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ALTERNATIVE POLICIES FOR MANAGING THE INTERNATIONAL DEBT CRISIS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

JUNE 24, 1986

Printed for the use of the Joint Economic Committee

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ALTERNATIVE POLICIES FOR MANAGING THE INTERNATIONAL DEBT CRISIS

TUESDAY, JUNE 24, 1986

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2203, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Scheuer.

Also present: Alfred Watkins and John Starrels, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. This morning we will have a short hearing on the Mexican debt situation and the entire question of the administration's management of our Third World debt problem.

The 1980's have been a decade of extraordinarily slow economic growth. The 2.3 percent average rate of economic growth during this decade is the most anemic of any decade since World War II.

A major reason for this lethargic economic performance is the dramatic decline in the U.S. trade balance. The United States entered the decade with a modest current account surplus. Since then, our cumulative external deficit has exceeded $275 billion, with another $100 billion to $125 billion expected to be added to that total in 1986.

Some of our trade problems are due to private sector decisions. But others can be traced to public policies which in some ways have been destructive or not especially constructive. Four mistakes in particular, at least in my judgment, have been especially damaging to the U.S. economy.

The first one has been the prolonged overvaluation of the dollar which gave our competitors a 30 to 40 percent price advantage and an extraordinary opportunity to expand their market share—both in the United States and overseas—at the expense of U.S. producers.

Second, our failure to, in some cases, aggressively defend American interests in international trade negotiations mean that many U.S. products are still barred from overseas markets while at least some foreign producers enjoy relatively easy access to U.S. markets.

Third, and this will be debatable in some quarters, but in my judgment, administration budget policies have slashed public in-

vestments which are needed to strengthen U.S. competitiveness and our ability to sell U.S. products overseas. For example, recent budget requests have called for the elimination of the Export-Import Bank and cutbacks in education and labor training programs needed to prepare the work force for the jobs of tomorrow.

Fourth—and this is the subject of this hearing this morning—the problem of what is regarded by some as mistaken policies in terms of the management of our Third World debt problem. Since the onset of the debt crisis nearly 4 years ago, our trade balance with Latin America has deteriorated from a $5 billion surplus to a $12 billion deficit. The administration's handling of the debt crisis has brought sharp reductions in U.S. exports to Latin America at the same time that they have caused Latin American debtors to flood world markets with cotton, wheat, beef, soybeans, and other products. This has resulted in a disastrous drop in world market prices along with other factors, and a drop in world market share for American farmers.

Those price declines have not made it easier for Latin American debtors to service their debts, nor are they helping to resolve the debt crisis. But they have pushed thousands of U.S. farmers closer to bankruptcy and, by some estimates, cost the U.S. economy nearly a million jobs as debtor nations are forced to reduce their consumption of U.S. products and increase their exports of competing products.

This committee has held several hearings during which various American business representatives have testified about the effect of the management of the Third World debt situation on their own ability to export most especially to Latin America.

A recent Joint Economic Committee staff report documented in greater detail the damage inflicted on the U.S. economy by the handling of the debt crisis. It demonstrates how our policies have permitted U.S. banks to maintain, and even increase, their profitability, even though those same policies have seriously—and unnecessarily—injured the economic well-being of other sectors of the U.S. economy and done little to permanently resolve the debt crisis.

Clearly, the time has come for a more dramatic change of course. We need a more far-sighted plan that gives debtor nations a chance to purchase U.S. products, a chance to export without engaging in ruinous competition in a glutted market situation, and a chance to put their economic houses in order without adding to their interest burdens. Today's hearing is aimed at helping Congress begin the process of not only identifying the damage but suggesting some long-range solutions that go beyond mere damage control or mere delay of the crunch.

Today's witnesses are Mr. Norman Bailey, former Special Assistant to President Reagan for International Economic Policy and currently a partner in the firm of Colby, Bailey, Werner & Associates. Our second witness is Mr. Robert Lorenz, recently retired executive vice president at Security Pacific Bank of Los Angeles, one of the nine major U.S. money center banks deeply involved in the Latin American debt problems.

The purpose of this hearing is to establish whether or not current administration policies do indeed offer a viable approach for

resolving the international debt crisis and how those policies are affecting various sectors of the U.S. economy as well as the political and economic health of the debtor nations. Today's witnesses will be asked to try to answer several important questions. Will the Baker plan enable debtor nations to increase their imports and economic growth rates while continuing to service their debts? Is encouraging commercial banks to extend new loans to countries that are already having trouble even paying interest on their old loans, as the administration has been urging for some time, the most appropriate way to resolve the debt crisis, increase the stability of the international financial system, and revive U.S. exports to Latin America? And most importantly, if not, what alternative policies should be considered by the administration and by the Congress?

I'd like to thank our witnesses for appearing before us today and for taking the time to share their views with us. I look forward to their testimony.

[The following material was attached to Representative Obey's opening statement:]

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Congress of the United States

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PAUL S. SARBANES, MARYLAND

ROBERT J. TOSTERUD
DEPUTY DIRECTOR

June 23, 1986

Dear Democratic Colleague:

The 2.3% average rate of annual economic growth during this Administration is one of the worst of any Administration since World War II. A major reason for poor economic growth during the Reagan era has been the remarkable reversal of our position in world trade. Despite the fact that this Administration inherited a trade surplus, we now are experiencing the worst trade deficits of any nation in history.

Some of our trade problems can be traced to decisions by the private sector. But a great deal of the deterioration in our trade position can be traced directly to public policies developed by this Administration. There are four basic areas where Reagan policies have contributed to the trade deficit:

1) The prolonged overvaluation of the dollar against the currencies of our trading partners. This provided our foreign industrial competitors with a 30 to 40% price advantage and an extraordinary opportunity to take away markets both here and overseas from American manufacturers.

2) Failure to aggressively defend American interests in international trade negotiations. Even Republicans have become frustrated with the Administration's limp-wristed approach toward unfair foreign trade practices. Fifty-nine (59) members of the President's own party voted for the Trade and International Economic Policy Reform Act when it came before the House last month.

3) Budget policies that slash public investments needed to strengthen our economy and our ability to sell American products abroad. Presidential budgets have repeatedly pushed for the elimination of the U.S. Export Import Bank and have proposed elimination of the language training programs needed if we are going to sell our products to people in the world that don't speak English. We have cut back on the statistical programs that provide information on the kinds of products likely to sell in foreign markets, and we have inadequately funded efforts to upgrade the quality of our work force ranging from adult literacy programs to improving curriculum in schools of engineering.

4) Mismanagement of the third world debt problem. Since President Reagan took office, our balance of trade with Latin America has deteriorated from a five billion dollar surplus to a 12 billion dollar deficit. Much of that deterioration has come as the result of Administration policies that protect not only the solvency but also the high profit levels of the large money center banks. These policies have not only brought sharp reductions in U.S. exports to Latin America, but have also caused Latin debtors to flood world commodity markets with beef, wheat, soybeans, pork and other products resulting in a rapid decline in both prices and world market share for American farmers.

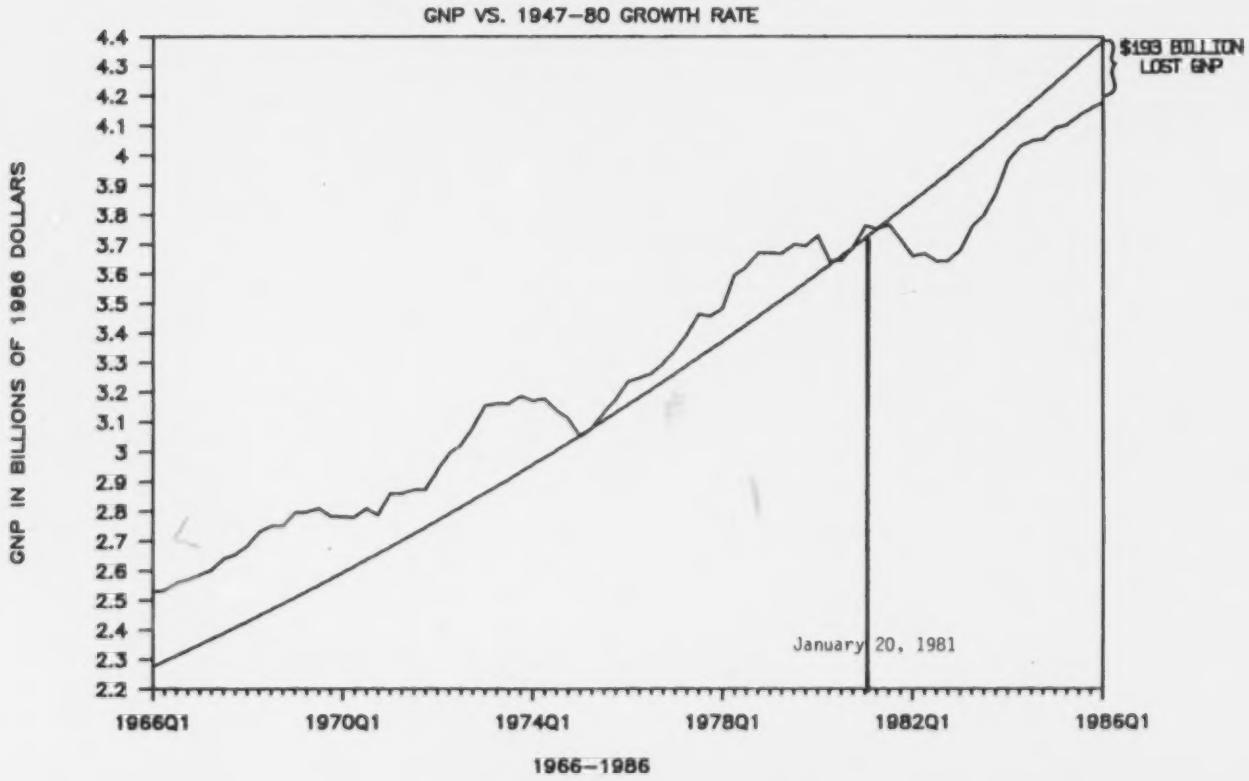
The last area is documented in considerable detail in a recent JEC study which I am enclosing. I think it will be helpful to most Members and could be useful to Members who represent districts engaged in agricultural export. If you have questions concerning the report, please call Al Watkins at 224-5171 or 224-0383.

Sincerely,

David R. Obey
Chairman

Enclosures

THE REAGAN GROWTH GAP



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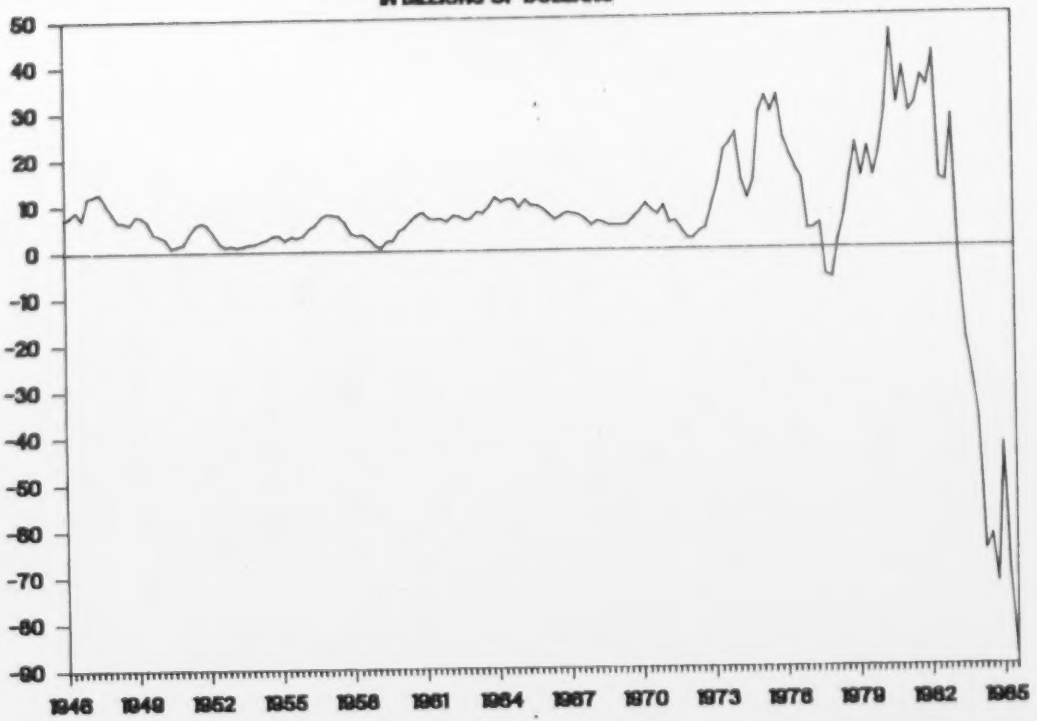
THE TRADE BALANCE

IN BILLIONS OF DOLLARS



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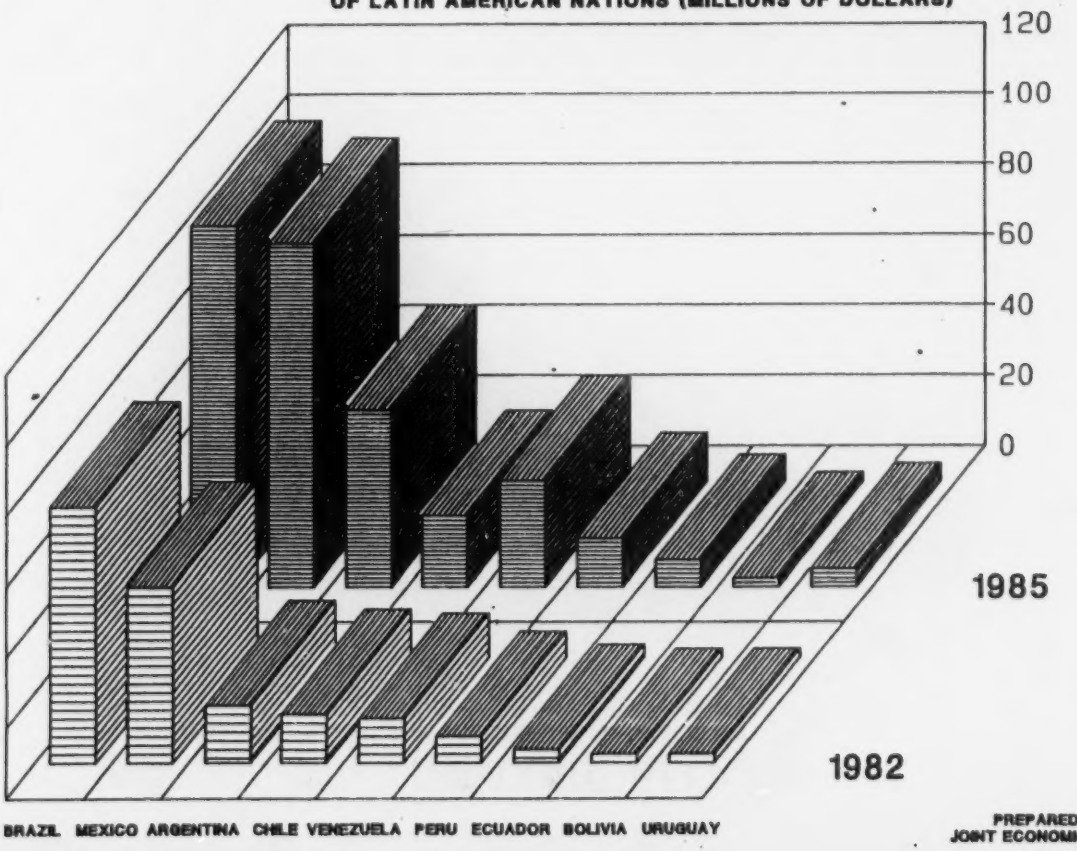
TOTAL DEBT

OF LATIN AMERICAN NATIONS (MILLIONS OF DOLLARS)



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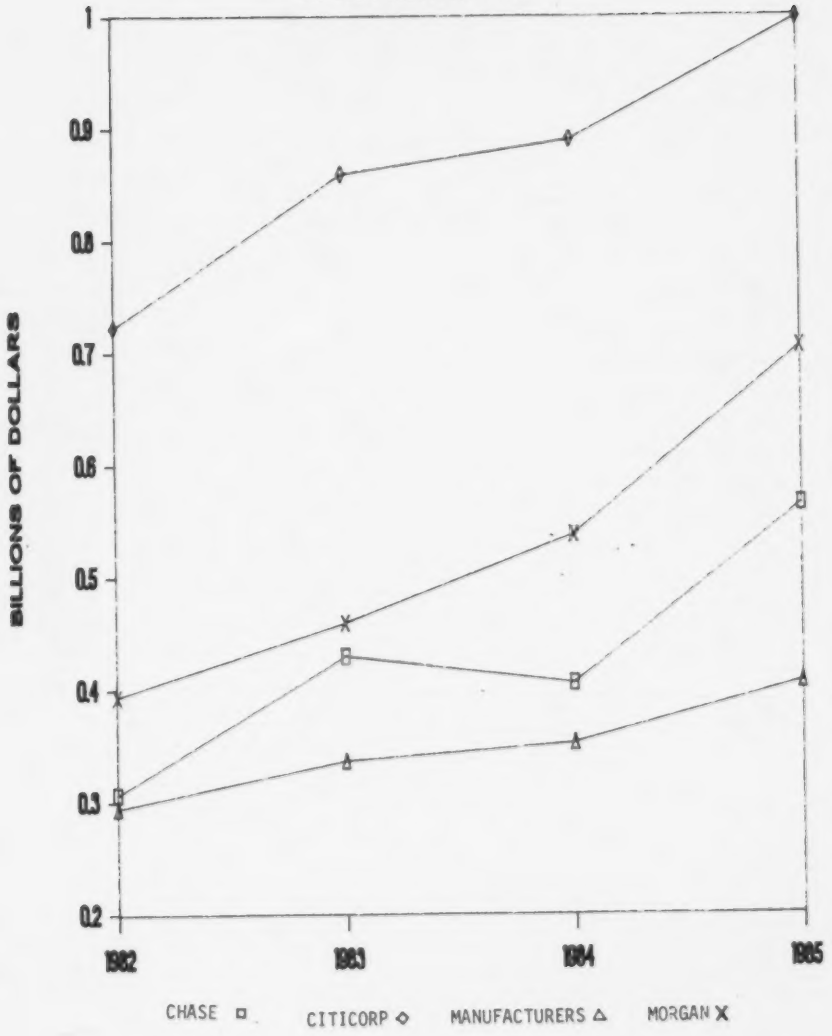
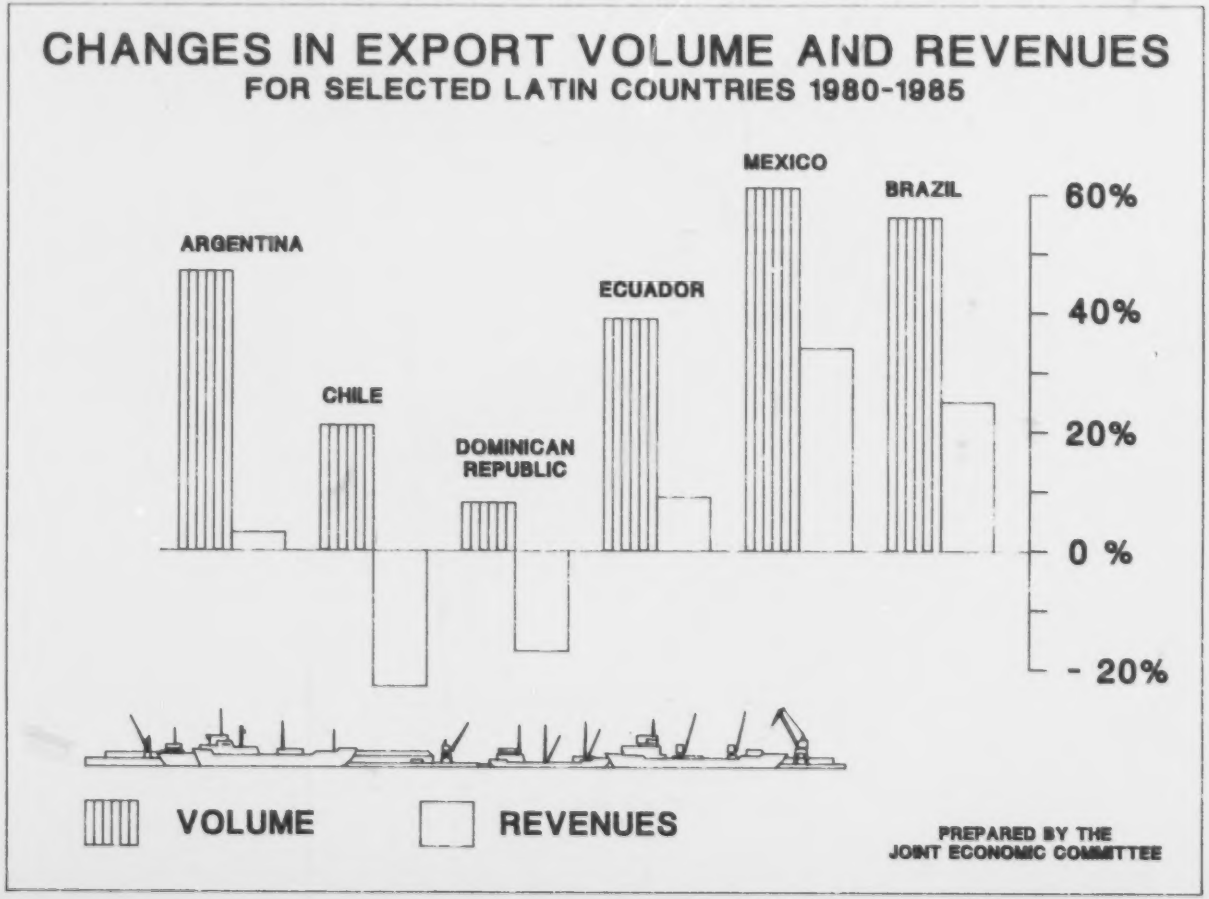
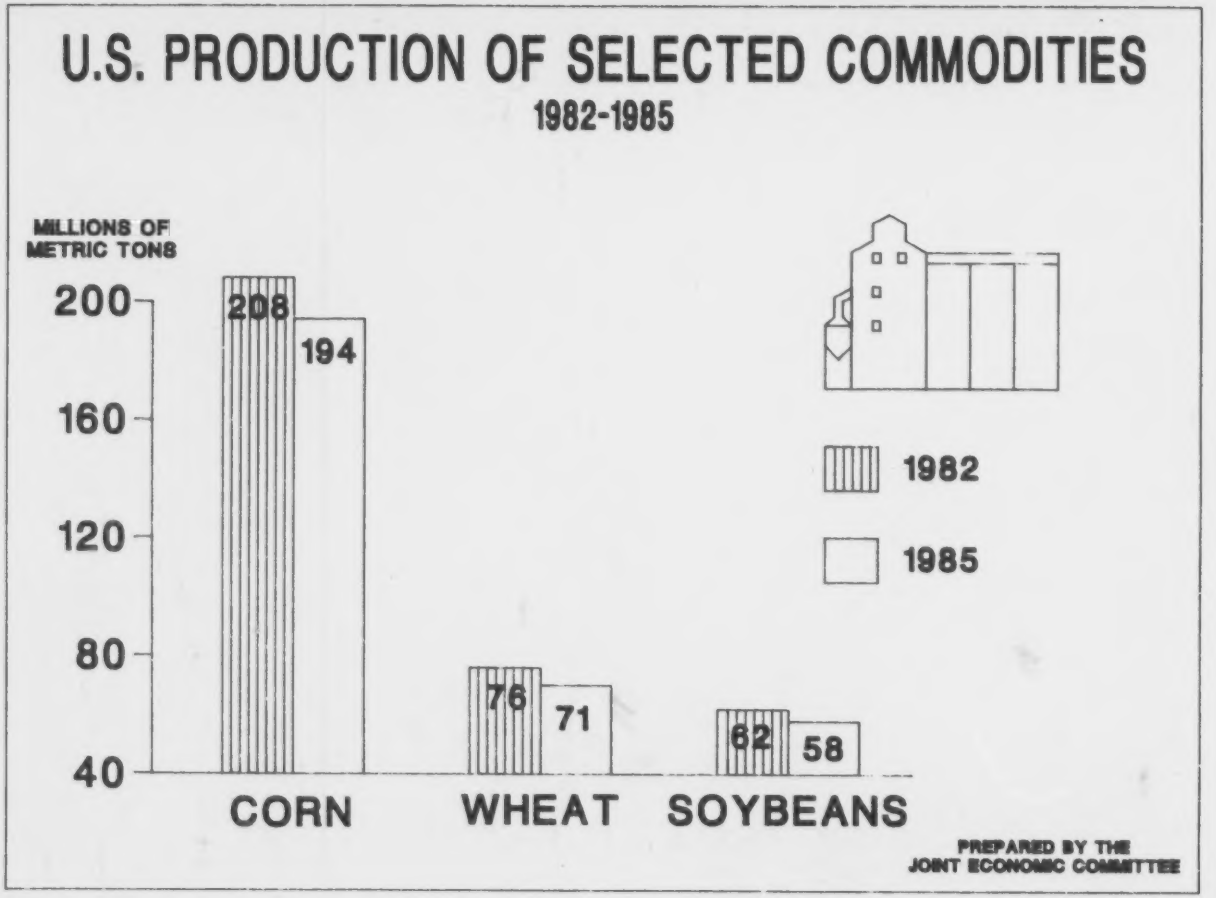
NET INCOME

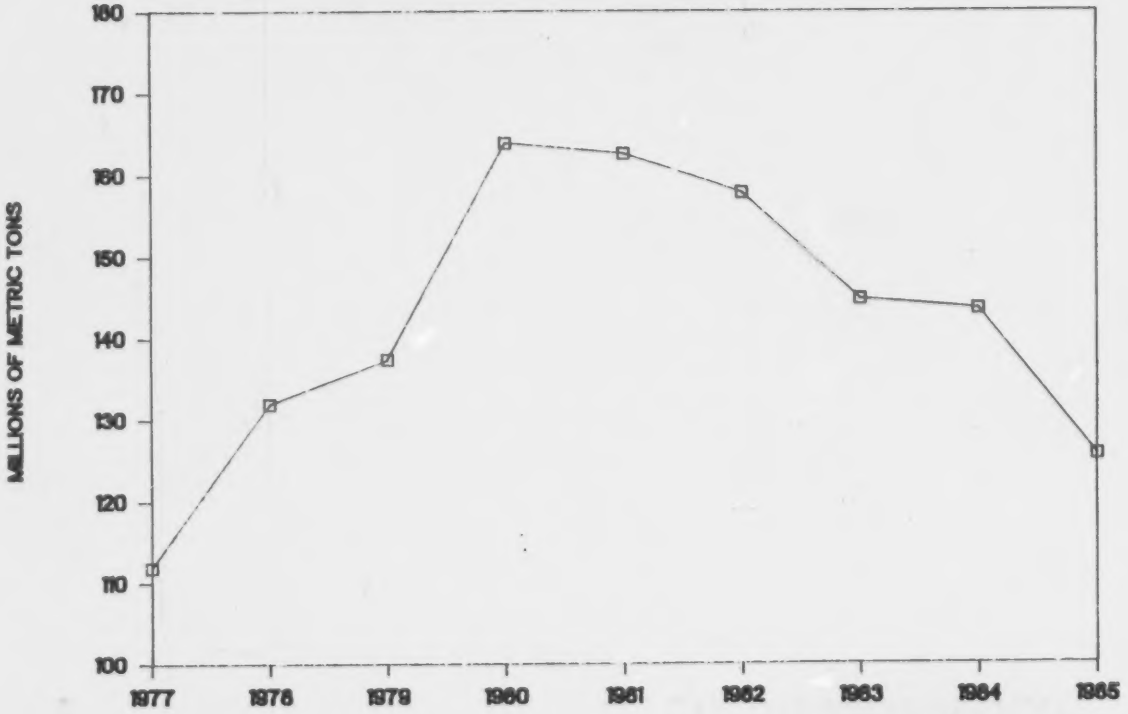
AT FOUR SELECTED BANKS




CHANGES IN EXPORT VOLUME AND REVENUES
FOR SELECTED LATIN COUNTRIES 1980-1985
ARGENTINA
CHILE
DOMINICAN REPUBLIC
ECUADOR
MEXICO
BRAZIL
60%
40%
20%
0 %
- 20%
VOLUME
REVENUES
PREPARED BY THE JOINT ECONOMIC COMMITTEE


U.S. PRODUCTION OF SELECTED COMMODITIES
1982-1985
MILLIONS OF METRIC TONS
200
160
120
80
40
208
194
76
71
62
58
1982
1985
CORN
WHEAT
SOYBEANS
PREPARED BY THE JOINT ECONOMIC COMMITTEE

VOLUME OF U.S. FARM EXPORTS



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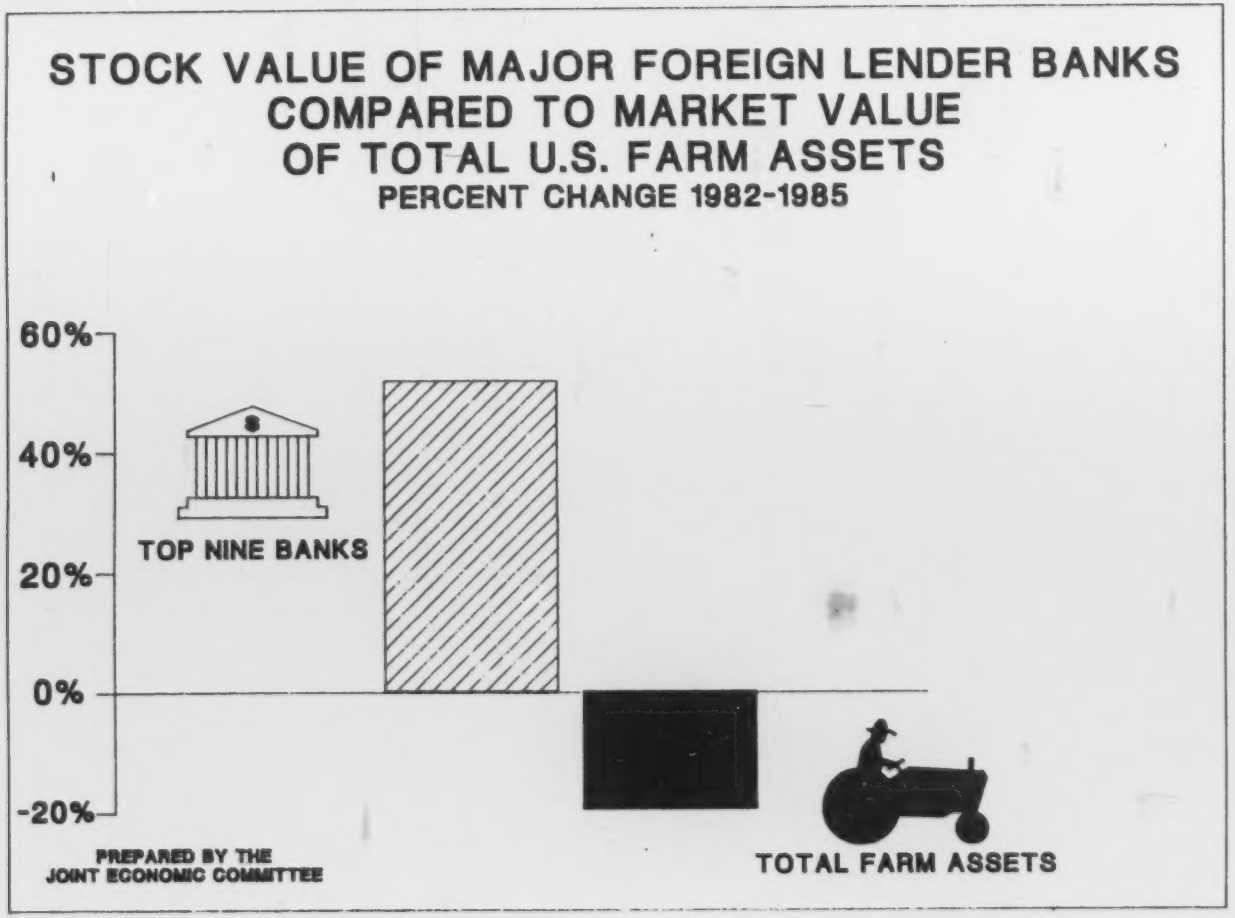
STOCK VALUE OF MAJOR FOREIGN LENDER BANKS
COMPARED TO MARKET VALUE
OF TOTAL U.S. FARM ASSETS
PERCENT CHANGE 1982-1985
60%
40%
20%
0%
-20%
TOP NINE BANKS
TOTAL FARM ASSETS
PREPARED BY THE
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THE IMPACT OF
THE LATIN AMERICAN DEBT CRISIS
ON THE U.S. ECONOMY

A STAFF STUDY

Prepared For The Use Of The

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

May 10, 1986

The Latin American debt crisis first burst upon the public consciousness in August 1982, when Mexico announced that it could not continue paying interest on its current debt obligations. By the end of the year, it became clear that Mexico was only one of nearly a dozen Latin American nations that had borrowed considerably more from U.S., European, and Japanese banks than their sluggish economies were capable of repaying on time.

When Mexico's financial difficulties first became front-page news, Latin American debtor nations had a total external debt of more than $318 billion, with yearly interest payments totaling $38.5 billion. Their trade surplus at the time was only $8.5 billion, or $30 billion less than they needed merely to pay interest.1/ And they needed tens of billions of additional dollars in order to repay the principal on time.

Most of Latin America's external debt was owed to a relatively small number of international commercial banks. According to a recent Department of State report, private creditors in 1982 accounted for 85 percent of Latin America's external debt. Official debt, such as loans from the International Monetary Fund (IMF), the World Bank, and the U.S. Government, made up the remainder.2/

U.S. commercial banks were especially vulnerable to economic developments in Latin America. With a total 1982 exposure of $83.9 billion, they held more than 25 percent of Latin America's

total debt and nearly one-third of the debt owed to all private creditors.3/ But as daunting as these numbers may be, they do not convey the full extent of the U.S. commercial banking system's stake in the Latin American debt crisis.

By the end of 1982, the U.S. commercial banking system's total exposure in Latin America equaled 119 percent of the total capital for all major banks. The Latin American exposure of nine money center banks equaled 176 percent of their combined capital. A bank is declared insolvent and closed by U.S. bank regulators when its loan losses consume its capital. Consequently, on average, all nine money center banks would have failed if the Latin American debtors announced they could repay only 40 percent of their outstanding debt. Even if they said that they would repay as much as 80 percent of the outstanding debt, the nine money center banks stood to lose more than 35 percent of their combined capital. Their ability to continue functioning and extending credit to U.S. borrowers would be seriously impaired. Clearly, U.S. officials were correct in perceiving that the debt crisis was a serious threat to the U.S. banking system -- and to the U.S. economy.

In early 1983, Administration officials devised a four-pronged strategy for ensuring that Latin American debtors would continue servicing their debts:4/

* Debtor nations would generate a large portion of the dollars they needed to pay interest by increasing their exports and cutting their imports;

- Debtor nations would be given more time -- in some cases, as much as 14 additional years -- in which to repay their maturing loans;

- Commercial banks would make new loans so that debtor nations could avoid falling behind on their interest payments to the banks; and

- The IMF, in addition to lending modest amounts of its own funds, would ensure that the debtors were implementing essential economic reforms.

All three groups -- the banks, the debtor nations, and the IMF -- announced that they intended to comply with this strategy. Latin American debtors, for example, reduced their imports from almost $100 billion in 1981 to approximately $60 billion today.5/ Most debtor nations also increased the volume of their exports. Since the beginning of this decade, the three largest Latin American debtors -- Argentina, Brazil, and Mexico, which together account for two-thirds of the region's total external debt -- increased the volume of their exports by 47 percent, 56 percent, and 62 percent, respectively.6/

In addition, commercial banks and the IMF extended new loans to help debtor nations pay interest on their old loans. As a result, Latin America's outstanding debt increased by $50 billion since the onset of the debt crisis -- it is now $368 billion -- and according to the plan announced last October by Treasury Secretary Baker in Seoul, Korea, it is scheduled to continue

rising for at least the next three years. Finally, the major Latin American debtors have adopted austere economic reform programs and agreed to extensive IMF monitoring of their economic policies and performance.

It was clear from the outset that the third world debt problem posed a serious, potentially even catastrophic, threat to the stability of the international financial system. Thus far, a financial catastrophe has been averted, which was the initial goal of policymakers. The evidence suggests, in fact, that the policies that were implemented have permitted U.S. banks to maintain and even increase their profitability. But, at the same time, those policies have seriously -- and unnecessarily -- injured the economic well-being of other sectors of the U.S. economy, agriculture and manufacturing in particular. And they have done little to permanently resolve the debt crisis.

INJURY TO THE U.S. FARM ECONOMY

The financial crisis down on the farm is well documented. Little attention, however, has been paid to the relationship between the international debt crisis and the financial difficulties of U.S. farmers.

Declining Farm Exports

There are several ways in which the international debt crisis injures U.S. farmers. First and most immediately apparent is the

decline in farm exports to Latin America. In 1981, for example, the U.S. Department of Agriculture reported:

> Developing countries continue to be the major growth area for U.S. farm exports. In Fiscal Year 1981, U.S. exports to these areas increased 19 percent to reach $16.9 billion. Annual growth was sustained at over 20 percent between Fiscal Years 1977 and 1981....Over half of U.S. wheat and soybean oil and four-fifths of U.S. rice exports went to developing countries in Fiscal Year 1981.7/

As a result of sales to these third world markets, U.S. farm exports hit an all-time high in 1981, totaling $43.8 billion. Without that agricultural trade surplus, the 1981 U.S. trade deficit would have been twice as large. Latin America's contribution to that export boom was considerable. It was the third largest market for U.S. farm exports, trailing only Western Europe and Japan. Between 1980 and 1981, the Latin American market absorbed almost one-half the total growth of U.S. farm exports.

When the debt crisis emerged in August 1982, however, Latin American markets contracted precipitously. In order to obtain dollars to pay interest on their external debt, debtor nations began reducing their purchases of all U.S. exports. Not surprisingly, this had dire consequences down on the farm.

At their peak in 1981, Latin American purchases of U.S. farm products totaled $6.9 billion, or 15 percent of total U.S. farm exports. In the wake of the debt crisis, however, U.S. agricultural exports to Latin America tumbled one-third below their 1981 level, to $4.5 billion. Nearly 20 percent of the

total decline in U.S. farm exports during those four years was the result of dwindling sales to Latin America.8/

To get a clearer picture of the importance of Latin American markets to U.S. farm prosperity, it is instructive to note that, at their respective peaks, U.S. exports to Latin America exceeded exports to the Soviet Union by 240 percent, or $4 billion. By 1985, U.S. agricultural exports to Latin America were $2.4 billion below their peak; sales to the Soviet Union, meanwhile, were only $500 million below their peak. In other words, by 1985, the Latin American debt crisis was nearly five times as damaging to U.S. farmers as reduced sales to the Soviet Union.9/

Falling Commodity Prices

The reduction of agricultural exports to Latin America is only one way in which the debt crisis is injuring U.S. farmers. In order to pay interest, debtor nations must increase their exports as well as reduce their imports. In other words, they must purchase less from the United States at the same time that they are producing more and competing more fiercely with U.S. producers for a share of world export markets. This is the second way in which the debt crisis damages U.S. farm prosperity.

This additional production and competition cuts into U.S. sales to non-debtor nations and places downward pressure on virtually all major commodity prices. Falling commodity prices, in turn, make it more difficult for U.S. farmers to continue servicing their debt and pushes many of them into bankruptcy. At

the same time, falling commodity prices also makes it more difficult for Latin American debtors to continue servicing their debt. And as their debt service difficulties mount, they are pressed to produce and export still more which, in turn, generates additional price declines and increases the financial strains on U.S. farmers. In other words, in the current international economic environment of high debt burdens and global overproduction, falling commodity prices are as much a consequence of the debt crisis as a cause of the debt crisis.

This vicious circle is not limited to agricultural commodities. Petroleum, tin, and copper have also experienced major price declines caused by worldwide overproduction. And although falling oil prices have received the bulk of the recent public attention, during most of this decade prices have tumbled for nearly every commodity exported by debtor nations.

Between October 1980 and October 1982, prices for all non-petroleum commodity exports declined 40 percent. After three years of economic recovery, the downward slides seem to be continuing. In 1985, world sugar prices dropped by 26.9 percent, wheat prices declined by nearly 10 pecent, corn prices fell by 19.2 percent, and soybeans declined in value by 19.0 percent. In each case, world market prices in 1985 were below their 1982 level and, in many cases, real commodity prices are at their lowest level in four decades.10/ Commodity prices have continued falling during the first four months of 1986 and, even excluding

petroleum, showed no signs of reversing their relentless decline any time soon.

The significance of falling commodity prices can be seen in Table 1, which compares the change in the volume of each country's exports with the change in its export revenues and external debt. For virtually every country, the story is the same: since the beginning of this decade, the external debt grew faster than export revenues, but the lag in export receipts cannot be attributed to an unwillingness of the debtors to boost their export volume. Rather, the failure of export revenues to keep pace is due almost entirely to falling commodity prices.

Global Overproduction

Many Americans are under the impression that the current farm crisis is due primarily to domestic overproduction. However, U.S. production and export statistics tell a different story.

For instance, while U.S. wheat production was increasing by six million metric tons (6 MMT) between 1981 and 1985, global wheat production was increasing by 75 MMT, or nearly 12 times as much (Table 2). During the same period, U.S. soybean output declined by 4 MMT, or 8 percent, while world output was rising by 2.7 MMT, or 5 percent. Indeed, U.S. soybean production has remained relatively constant in the 50 MMT range since 1978. Meanwhile, world production increased by 15 percent. Similarly, while world corn output increased by 22 MMT since the beginning of the decade, U.S. output was falling by 6 MMT, or 3 percent.

TABLE 1

CHANGES IN EXPORT VOLUME, EXPORT REVENUES, AND EXTERNAL DEBT, 1980-1985

Country	Percent Change Volume Of Exports 1980-1985	Percent Change Export Revenues 1980-1985	Percent Change In Total External Debt 1980-1985
Argentina	47	3	46
Bolivia	-35	-38	31
Brazil	56	25	33
Chile	21	-23	43
Dominican Republic	8	-17	33
Ecuador	39	9	37
Mexico	62	34	41
Peru	- 3	-24	30
Uruguay	1	-20	57
Venezuela	-21	-25	13

Source: Economic Commission for Latin America, Preliminary Overview of the Latin American Economy 1985, December 1985, Table 7 and Table 15.

TABLE 2

PRODUCTION OF SELECTED COMMODITIES, 1977-1985

	(Millions Of Metric Tons)					
	Corn		Wheat		Soybeans	
Year	U.S.	World	U.S.	World	U.S.	World
1976-1977	157.9	336.3	58.5	421.2	47.9	72.1
1977-1978	161.8	364.9	55.7	384.2	50.8	77.2
1978-1979	184.6	390.0	48.3	446.8	61.7	93.7
1979-1980	201.7	423.7	58.0	423.3	48.7	80.8
1980-1981	168.8	406.7	64.6	441.1	54.4	86.2
1981-1982	208.3	437.4	76.1	448.2	61.9	95.2
1982-1983	213.3	437.7	76.4	472.9	44.5	82.3
1983-1984	106.0	350.0	65.9	489.4	50.6	89.7
1984-1985	194.5	445.3	70.6	516.0		

Source: Commodity Research Bureau, Commodity Year Book, 1983 and 1985 editions.

Rising world production levels helped spark the dramatic decline in U.S. farm exports. The volume of U.S. agricultural exports peaked in 1980 at 163.9 MMT and then fell by 40 MMT, or 25 percent, between 1980 and 1985 (Table 3). Export volume is projected to decline by an additional 4 or 5 percent in 1986. In the wake of this protracted decline, 1985's export volume is now below the 1978 level.

The value of U.S. farm exports also declined precipitously. After growing at a 17 percent annual rate between 1978 and 1981 and peaking at $43.8 billion, agricultural exports fell at a 7 percent annual rate starting in 1982. This downward trend is projected to continue in 1986 at more or less the same pace. At $31.2 billion, export revenues are at their lowest level since 1979.

TABLE 3

TRENDS IN U.S. FARM EXPORTS, 1977-1985

Year	Volume (MMT)	Value (Billions of $)
1977	111.9	$24.0
1978	131.9	27.3
1979	137.4	32.0
1980	163.9	40.5
1981	162.6	43.8
1982	157.9	39.1
1983	144.8	34.8
1984	143.6	38.0
1985	125.7	31.2

Source: Congressional Research Service, Patterns in Trade of Selected U.S. Agricultural Exports, Report #86-510, January 30, 1986, Table 2 and 3.

Increased Latin American Grain Exports

Although it would be an oversimplification to attribute these declines solely to the international debt crisis, it would be equally misleading to ignore the enormous impact of the crisis on world commodity markets since 1982. While U.S. production and exports have been declining, debtor nations in general, and Argentina and Brazil in particular, have greatly expanded production and, as statistics concerning the increasing incidence of malnutrition in both countries indicate, they have increased their exports even more rapidly than production. In large measure, their success in boosting exports has come at the expense of U.S. farm exports.

During the 1981/1982 crop season, for example, world wheat exports were 101.3 MMT. The United States supplied 48 percent of the world's wheat exports and Argentina supplied only 4 percent. By the 1984/1985 season, world wheat exports had risen 7 percent, to 108 MMT. U.S. exports, however, had fallen in absolute terms by 10.7 MMT and, in relative terms, to 35 percent of the world wheat market. Meanwhile, Argentine exports were doubling to 8.6 MMT.11/

Soybean exports show a similar trend. Between 1981/1982 and 1984/1985, world soybean exports declined by 4.4 MMT, or by 15 percent. U.S. soybean exports fell 36 percent, or by 9 MMT. Meanwhile, Brazilian soybean exports were quadrupling and Argentina's were doubling. Together, they now constitute 27 percent of the world soybean market, up from only 9 percent three

years earlier.12/ Meanwhile, a recent report from Sao Paulo, Brazil, indicates that the number of malnourished Brazilian children increased by 23 million over the past 10 years.13/ And in virtually all debtor nations, a typical IMF adjustment program calls on debtor nation governments to reduce domestic food price subsidies, thereby restricting domestic food consumption and contributing to the growing incidence of malnutrition.

Farm Bank Failures

Because the Latin American debt crisis has seriously injured U.S. farmers, it has also contributed to the collapse of numerous farm banks.

The number of farm bank failures rose by nearly 900 percent between 1982 and 1985 (Table 4). By 1985, more than 50 percent of total bank failures in the preceding three years were farm banks, even though only 25 percent of all commercial banks are classified as farm banks. In addition, from 1984 to 1985, the number of bank failures rose from 79 to 120. Approximately 90 percent of the increase was due to the higher incidence of farm bank failures.14/ And according to recent Federal Reserve Board analysis, anywhere between 400 and 1,400 additional farm banks are in danger of failing in the near future.15/

TABLE 4

BANK FAILURES, 1982-1985

Institution	1982	1983	1984	1985
Agricultural Banks	7	7	25	62
Other Commercial Banks	27	38	53	56
Savings Banks	8	3	1	2
Total	42	48	79	120

Manufacturing businesses and their employees are also victims of the international debt crisis. According to recent estimates, more than one million U.S. jobs have been lost because the debt crisis has forced debtor nations to reduce their consumption of U.S. products and increase their exports of competing products to the United States.16/

BANK PERFORMANCE SINCE THE DEBT CRISIS

The use of public policy to prevent the debt crisis from sparking failures among the money center banks represents, in many respects, a significant philosophical departure for the Reagan Administration. From the beginning, their debt crisis policy was overtly interventionist. This marked a striking departure from the Administration's professed laissez-faire principles which, if applied consistently, would have permitted the banks to fail. Instead of trusting the invisible hand to solve the debt crisis, the Reagan Administration marshalled the power of the Federal Government and the resources of the U.S. Treasury to preserve the solvency of the U.S. banking system and shelter individual banks from the consequences of their ill-advised lending decisions. Most experts agree that the Administration should be applauded for its willingness to abandon its free market ideology when that ideology showed every indication of threatening the safety and soundness of the international and U.S. financial systems.

But the decision to intervene and avert a financial collapse was only a first step. The second step should have been to consider -- and minimize -- the impact of the debt crisis on the U.S. economy. Unfortunately, there is little evidence that the policies implemented since August 1982 were subjected to this second step procedure.

Preserving Solvency or Promoting Profitability?

Indeed, it is now becoming clear that Administration policies have gone above and beyond what was needed for protecting the money center banks from insolvency. Besides preserving their safety and soundness, the Administration ensured, and in fact promoted, their profitability. Comparing the fortunes of stockholders in the money center banks with those of American farmers and manufacturing exporters indicates that the Reagan Administration's management of the debt crisis has, in effect, rewarded the institutions that played a major role in precipitating the crisis and penalized those sectors of the U.S. economy that had played no role in causing the debt crisis.

From the outset, the Administration made only one request of the banks -- that they continue lending modest amounts of new money to hard-pressed debtor nations. This request was in the banks' self-interest. Without new bank loans, debtor nations would be have difficulty making timely interest payments. And if debtors failed to continue servicing their bank loans, reported bank profits would fall.

The money center banks' record of compliance has been less than enthusiastic (Table 5). Between June 30, 1982, and December 31, 1985, the nine money center banks increased their loans to Mexico by $0.64 billion, and to Brazil by $3.8 billion. During the same period, they increased their loans to Argentina by $0.5 billion and to Chile by $0.7 billion. They decreased their loans to Venezuela by $0.2 billion. From the beginning of the debt crisis to the end of 1985, the nine money center banks increased their total Latin American exposure by only $1.8 billion. This amounts to a 3.5 percent increase in three years.

Benefits to Bank Stockholders

Even though these nine banks provided a meager amount of the new money that was used to alleviate the debt crisis, their stockholders have clearly been the major -- indeed, possibly the only -- beneficiaries of Administration policies.

TABLE 5

NINE MONEY CENTER BANKS' EXPOSURE TO
MAJOR LATIN AMERICAN DEBTOR NATIONS, 1982-1985

Country	(Millions of Dollars) June 30, 1982	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984	Dec. 31, 1985
Argentina	$ 5,331	$ 5,125	$ 5,354	$ 5,270	$ 5,874
Brazil	11,775	13,296	14,127	15,397	15,550
Chile	3,364	3,327	3,439	3,823	4,067
Columbia	1,859	2,225	2,524	2,147	1,923
Mexico	13,443	12,862	13,298	14,553	14,087
Venezuela	7,313	7,804	7,636	7,456	7,127

Source: Federal Financial Institutions Examination Council, Country Exposure Leading Survey.

From the earliest days of the debt crisis, banks increased their spreads -- the difference between the interest rate they charge on loans and the interest rate they pay for loanable funds -- on loans to the most financially hard-pressed debtor nations. In 1980, spreads on syndicated Eurodollar loans to developing countries averaged 86 basis points. (A basis point is one one-hundredth of a percentage point.) Oil exporting developing countries like Mexico and Venezuela were borrowing money on even more favorable terms. In 1980, their spreads were as low as 66 basis points.17/ By 1983, however, while the U.S. Government and IMF were making emergency loans to keep debtor nations solvent, banks were tripling the spread they were charging on rescheduled loans to these same borrowers, raising them to more than 225 basis points. Since 1983, spreads have been reduced somewhat. But at 125 basis points, they are still averaging nearly 50 percent more than their pre-debt crisis level.18/

These higher profit margins on loans to debtor nations were quickly translated into higher profits at the money center banks. During 1985, for example, after-tax profits rose by 12 percent at Citicorp, 39 pecent at Chase Manhattan, 16 percent at Manufacturers Hanover, 31 percent at Morgan Guaranty, 15 percent at Chemical, 21 percent at Bankers Trust, and 96 percent at First Chicago (Table 6). Continental Illinois converted a $1 billion loss in 1984 into a $134 million profit in 1985. Bank of America was the only member of the top nine to register a loss.

TABLE 6

NET INCOME AT NINE MONEY CENTER BANKS, 1982-1985

Money Center Bank	(Millions of Dollars) 1982	1983	1984	1985
Bankers Trust	$ 223	$ 257	$ 307	$ 371
Bank of America	395	390	346	-337
Chase Manhattan	307	430	406	565
Chemical	241	306	341	390
Citicorp	723	860	890	998
Continental Illinois	84	101	-1,088	134
First Chicago	137	184	86	169
Manufacturers Hanover	295	337	353	407
Morgan Guaranty	394	460	538	705
Total	$2,799	$3,325	$2,179	$3,402

Source: Salomon Brothers, Inc., A Review of Bank Performance: 1986 Edition. For Continental Illinois, "Annual Scoreboard of 200 Banks," Business Week, various issues.

Their 1985 performance was not an aberration. Bank profits have grown steadily since the onset of the debt crisis. Between 1982 and 1984, after-tax income rose by $167 million at Citicorp, $99 million at Chase Manhattan, $58 million at Manufacturers Hanover, $144 million at Morgan Guaranty, $100 million at Chemical, and $84 million at Bankers Trust. Profits during this period did decline at Bank of America, First Chicago, and Continental Illinois. But it would appear that these declines occurred because of banking decisions unrelated to Latin American lending and in spite of the Administration's debt crisis policies, since none of the banks suffered significant losses on the syndicated loan portion of their Latin American portfolio.

Not surprisingly, bank stock prices and dividends increased along with profits. Total dividends increased by nearly 33 percent in the three years following the onset of the debt crisis, rising from a total payout of approximately $1.2 billion in 1982 to almost $1.6 billion in 1985 (Table 7). This increase, moreover, cannot be attributed solely to an increase in the number of shares outstanding. Dividends per share were also growing. At Bankers Trust, Chemical, Citicorp, and Morgan Guaranty they grew at a compound annual rate of approximately 9 percent.

TABLE 7

TOTAL DIVIDENDS DECLARED, 1982-1985

Money Center Bank	(Millions of Dollars) 1982	1983	1984	1985
Bankers Trust	$ 71.2	$ 81.0	$ 92.0	$ 106.6
Bank of America	229.4	291.5	307.5	246.7
Chase Manhattan	162.4	173.1	209.3	229.4
Chemical	103.8	129.8	150.0	155.8
Citicorp	222.0	271.0	319.0	353.0
Continental Illinois	80.0	83.0	25.0	0.0
First Chicago	50.9	73.3	93.1	94.6
Manufacturers Hanover	125.4	154.4	196.2	197.7
Morgan Guaranty	136.0	168.0	190.0	210.0
Total	$1,181.1	$1,425.1	$1,582.1	$1,593.8

Source: See Table 6.

In addition to receiving higher dividends, shareholders also profited from a substantial increase in stock prices (Table 8). With the exception of Continental Illinois and Bank of America, share prices rose at the seven other money center banks. A portfolio consisting of 100 shares of each of the nine money center banks would have increased in value from $23,658 at the end of 1982 to $32,509 at the end of 1985, and $39,214 on April 30, 1986, even after the price declines on Continental Illinois stock are factored into the calculations.

THE BAKER PLAN

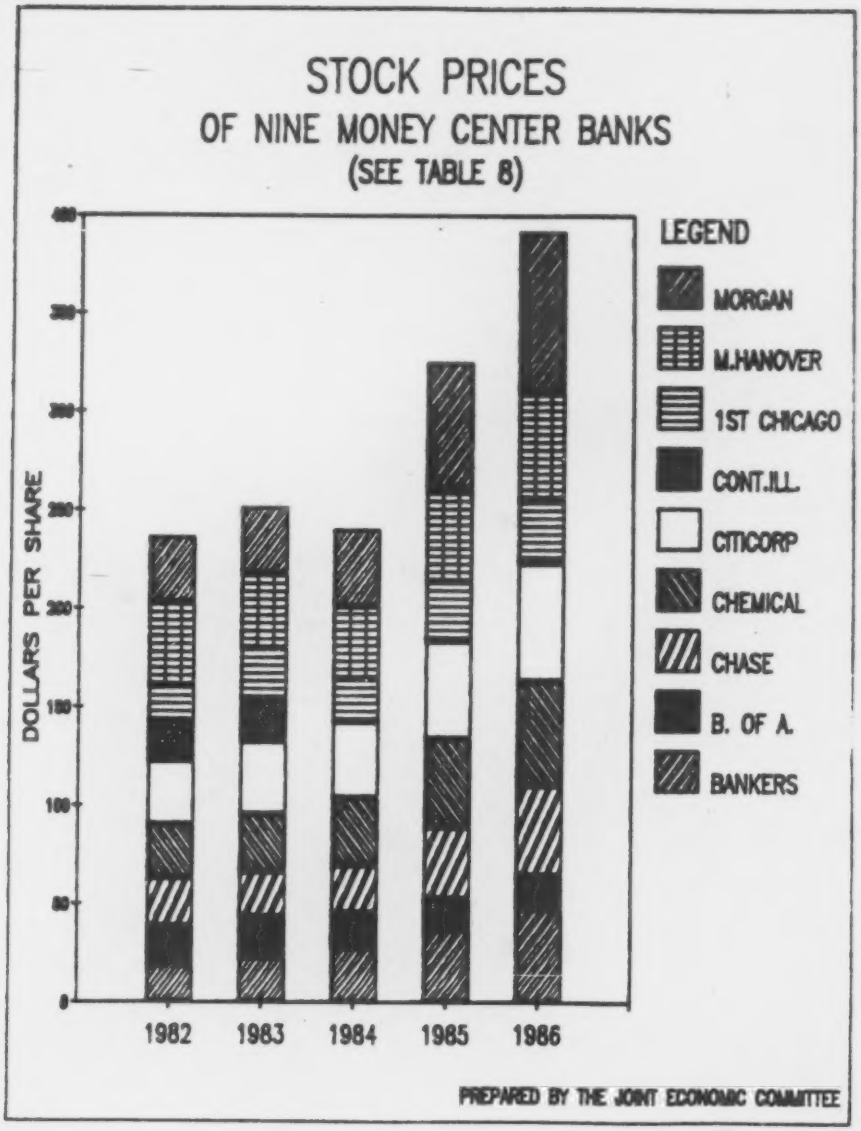
The Administration is now putting forward a new initiative, the Baker Plan.19/ It argues that this initiative is a dramatic departure from previous policies because it shifts the emphasis from austerity to growth. In particular, the Baker Plan calls on commercial banks to make $20 billion of new loans, debtor nations to continue making structural economic adjustments, and the World Bank to make $9 billion of new loans that were formerly made by the IMF.

TABLE 8

MARKET PRICE PER SHARE OF COMMON STOCK, 1982-1986

Money Center Bank	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984	Dec. 31, 1985	April 30, 1986
Bankers Trust	$18.56	$22.56	$27.38	$36.75	$47.25
Bank of America	20.13	20.88	18.13	15.63	17.25
Chase Manhattan	24.50	22.75	23.88	36.31	45.63
Chemical	27.00	29.33	34.50	45.38	53.25
Citicorp	32.50	37.13	38.75	49.38	59.75
Continental Illinois	20.38	21.88	0.50	0.88	2.00
First Chicago	18.13	25.38	21.38	29.50	30.75
Manufacturers Hanover	41.63	38.00	36.63	47.13	54.13
Morgan Guaranty	33.75	33.69	39.25	64.13	82.00

Source: Same as Table 6.


STOCK PRICES
OF NINE MONEY CENTER BANKS
(SEE TABLE 8)
DOLLARS PER SHARE
0
1982
1983
1984
1985
1986
LEGEND
MORGAN
M.HANOVER
1ST CHICAGO
CONT.ILL.
CITICORP
CHEMICAL
CHASE
B. OF A.
BANKERS
PREPARED BY THE JOINT ECONOMIC COMMITTEE

Aside from changing the rhetoric from austerity to growth and shifting responsibility from the IMF to the World Bank, it does not appear that the Baker Plan differs significantly from existing policy. In particular, it is doubtful that the amount of increased lending called for by the Baker Plan will be sufficient -- absent other initiatives relating to the conditions of debt service -- either to reduce current pressures on debtor nations to expand exports or permit them to boost their growth, investment, and imports.

Growth or Interest Payments?

As the financial data presented in Table 9 reveal, except for the Dominican Republic, all the major Latin American debtor nations are generating large trade surpluses. In Argentina, Brazil, and Venezuela, exports were at least twice as large as imports. In other words, with a more conducive external debt environment, these countries could have doubled their imports. Most of the other countries could also boost their imports substantially. The amount ranges from 14 percent in Uruguay to 61 percent in Peru. In dollar terms, the total trade surplus of these 10 Latin American debtors is $35.6 billion. Since a large part of that trade surplus was generated by reducing their purchases of U.S. products, it stands to reason that U.S. exporters and their employees would benefit the most from a revision of Administration policies.

TABLE 9

FINANCIAL INDICATORS OF MAJOR LATIN AMERICAN DEBTOR NATIONS, DECEMBER 31, 1985

	(In Millions)					
Country	(1) Goods Exports	(2) Goods Imports	(3)=1-2 Trade Balance	(4) Interest Payments	(5) Current Account	(6) Total Debt
Argentina	8,300	3,680	4,620	5,510	-1,600	50,000
Bolivia	580	430	150	430	- 370	3,190
Brazil	25,200	12,800	12,400	11,540	- 700	101,930
Chile	3,640	2,930	710	1,820	-1,350	19,580
Dominican Republic	800	1,090	-290	300	- 200	2,760
Ecuador	2,770	1,730	1,040	840	- 140	7,300
Mexico	21,500	13,500	8,000	9,000	- 550	97,700
Peru	2,970	1,860	1,110	1,220	- 230	13,750
Uruguay	850	740	110	350	- 200	4,900
Venezuela	14,300	6,600	7,700	1,520	+4,400	30,300

Source: Economic Commission of Latin America, Preliminary Overview of the Latin American Economy 1985, December 31, 1985, Tables 12, 13, and, 15.

However, because of their debt service expenses, debtor nations cannot afford to increase their imports. In fact, as column 4 indicates, additional rounds of import restrictions and export promotion will probably be required if debtor nations are to continue paying interest. With the exception of Ecuador and Venezuela, interest payments exceed the trade surplus in every Latin American nation. (These data precede the recent interest rate and oil prices declines which have improved the position of Argentina and Brazil and worsened that of Ecuador, Venezuela, Peru, and Mexico.)

To make matters worse, the difference between the merchandise trade balance and interest payments underestimates the additional import restraints each country must impose. In addition to merchandise imports, every country must also pay for various other items, such as insurance, freight, and legal and accounting services. Subtracting the cost of merchandise imports, interest payments, and these other ancillary items from export earnings generates the current account balance.

As column 5 indicates, with the exception of Venezuela, every Latin American debtor nation ran a current account deficit in 1985. In other words, after all expenses are taken into account, debtor nations were still not generating enough export earnings to operate on a pay-as-you-go basis. Comparing these current account deficits to the amount of new loans envisioned by the Baker Plan leads to the inescapable conclusion that the vast

majority of new funds will be used to pay interest, rather than to stimulate growth, imports, and development.

Impact on U.S. Farm Economy

Although there is little chance that the Baker Plan will promote increased U.S. exports to Latin America, there is a significant chance that it will lead to further declines in international commodity prices and U.S. farm exports.

A good example of the adverse impact the Baker Plan could have is the recently announced $350 million World Bank loan to Argentina. The World Bank announcement stressed that this loan was proof that the Bank can dispense its share of the money called for in the Baker Plan. What the announcement failed to highlight is that Argentina is getting its $350 million World Bank loan on condition that it reduce its tax on agricultural exports in order to expand the amount of land devoted to wheat and soybean production.

Under the existing export tax, Argentine farmers do not receive the prevailing world market price when they export their crops. Instead, the government claims approximately 35 percent of the world market price in the form of an export tax. Farmers keep the remaining 65 percent. According to the World Bank, this tax constitutes a serious impediment to exports. Reducing it, therefore, should encourage Argentine farmers to boost exports -- primarily wheat, corn, and soybeans -- by as much as 6.5 MMT, according to official World Bank projections.20/

The World Bank recognizes that, in the current economic environment, boosting food exports may reduces world market prices. But it believes that falling prices will not place an intolerable burden on Argentine farmers. In the first place, it notes that "there is substantial scope for greater use of fertilizer and other inputs and for investment in infrastructure and equipment to enhance production."21/ Argentine wheat yields, for example, are only 70 percent of those in the United States, "in large measure, reflecting the use of insufficient technological packages in response to unfavorable pricing policies."22/ Reducing the export tax, the World Bank believes, will increase export profitability and, consequently, the incentive to employ better "technological packages."

The World Bank forecasts that higher yields resulting from modern technology will reduce per unit costs faster than the increased output reduces world market prices. Consequently, it reports that "in the event that international commodity prices decline even further than anticipated, Argentina should be able to continue to compete and find suitable markets for its products because of its competitive production advantage."23/

The World Bank analysis leaves two important questions unanswered. Who will purchase Argentina's additional agricultural exports? And since world export markets are not expected to grow rapidly, which country's exports will decline so that Argentina's exports may increase?

There would appear to be several potential customers for Argentina's additional agricultural exports. One obvious candidate is the Soviet Union, currently Argentina's biggest grain customer. The Soviet Union was recently awarded a contract to expand and modernize grain handling facilities at Bahia Blanca, Argentina's second largest port. After the expansion and modernization work is completed, annual grain export capacity is expected to increase by approximately 5 MMT. The Argentines might pay for this port modernization project by increasing their grain shipments to the Soviet Union. If so, Baker Plan funds will help to ensure that the Soviet Union will not need to increase its U.S. grain purchases. (Of course, as a result of the recent nuclear reactor accident, the Soviets may increase their grain purchases from a wide variety of foreign suppliers, in which case some of the adverse impacts on U.S. farmers could be reduced.)

Another obvious candidate is Japan. The Reagan Administration is currently pressuring the Japanese to take a more active role in resolving the debt crisis. If the Japanese comply by increasing their purchases of Argentine farm products, U.S. farmers could once again be the biggest losers. Japan is currently the number one market for U.S. agricultural exports. Although current trade frictions with the United States would seem to militate against Japan reducing its purchases of U.S. farm products, the Japanese could decide to comply with the Reagan Administration's wishes by refusing to increase their consumption of U.S. farm products.

In this respect, it is also important to point out that the recent decline of the dollar against the yen will not give U.S. farmers a competitive advantage over Latin American farmers. As part of their economic adjustment programs, both Argentina and Brazil devalued their currencies and then pegged them to the dollar. Consequently, both the austral and cruzado will rise and fall in tandem with the dollar and will always remain below the dollar in value. In other words, Argentina and Brazil will appropriate a significant portion of the benefits that U.S. farmers hoped to reap from a falling dollar.

A final set of candidates for purchasing the additional Argentine farm exports is Brazil and Mexico. Both nations might arrange to barter oil and manufactured goods for Argentine farm products. This barter arrangement could benefit the banks at the expense of U.S. farmers and U.S. export manufacturers. Argentina would reduce the amount of dollars it spends importing oil and manufactured goods. Brazil and Mexico would reduce the amount of scarce foreign exchange they spend purchasing U.S. food exports. In effect, all three debtor nations will have more dollars to pay the banks because they would all be purchasing less from the United States.

Impact on International Financial Institutions

As this analysis indicates, in deciding how to evaluate the Baker Plan, U.S. businesses, workers, and farmers must decide whether this most recent Administration initiative is in their

best interests. Will more loans whose primary purpose seems to be ensuring that debtor nations continue paying interest to commercial banks help U.S. farmers and U.S. exporters? Or will they merely continue to preserve bank profits at the expense of U.S. farmers and U.S. exporters?

Policymakers must also begin to examine the way in which the Reagan Administration is transforming the international financial institutions in the wake of the debt crisis. International financial institutions, such as the World Bank, the Inter-American Development Bank, and the IMF have always played a crucial role in promoting economic growth, trade, and development. The IMF ensures that member nations adopt effective adjustment policies designed to eliminate short-term balance of payments problems. The World Bank was chartered to help developing nations finance long-term development projects. Both institutions are charged with fostering sustained, orderly world growth and an environment of open markets and free trade. Neither was meant to function as a debt collection agency for the banks or to stifle world trade and growth in order to preserve bank profitability. Yet that is how the Reagan Administration is using them.

ALLEVIATING THE BURDEN ON U.S. FARMERS

Critics charge that the IMF and World Bank are the major cause of the problems outlined above. That indictment, however, assumes that the policies advocated by Administration officials

and implemented at their direction by both the World Bank and IMF were the only feasible way of containing the debt crisis. Fortunately, that is not correct. A careful examination of the wide range of alternatives indicates that there are a number of ways in which the Administration could have minimized the damage to the U.S. economy while, at the same time, preserving the integrity, safety, and soundness of the commercial banking system.

As the following two illustrative numerical examples indicate, a different set of policies would have yielded substantial benefits to the U.S. economy without imperiling the profitability of the nine money center banks. Similarly, neither example would have absolved debtor nations from undertaking needed structural reforms and eliminating corruption and capital flight. On the contrary, both could have been premised on continued economic adjustment and designed to facilitate and finance that process.

Example I

One possible approach would have been to ask the commercial banks to reduce or eliminate their spread -- the difference between the interest rate they charge on loans and the interest rate they pay for loanable funds -- on loans to financially troubled debtor nations. Under this approach, banks would have no longer earned profits on their Latin American loans, but they would not have lost money on them either.

According to a December 1985 Department of State report, Latin America's 1985 debt to private creditors, primarily commercial banks, totaled $309 billion.24/ If banks had eliminated their 125 basis point spreads, Latin America's debt service costs would have declined by $3.86 billion, or 10 percent of the interest actually paid in 1985. The amount of export earnings devoted to interest payments, and therefore not available for purchasing U.S. products, would have declined from 36 percent to 32 percent.

A reduction of this magnitude would not have imposed a dangerous burden on the U.S. commercial banks involved. According to the Department of State, the nine U.S. money center banks held one-sixth of the total Latin American debt owed to private creditors. Their pretax, pro-rata share of the $3.86 billion debt service reduction, therefore, would have been $643 million. By comparison, their combined 1985 after-tax profits were $3.4 billion, even after including the $337 million loss at Bank of America.

In after-tax terms, this $643 million decline in revenues translates into a $321 million reduction in after-tax profits. Their 1985 after-tax profits would have been 10 percent lower than initially reported. However, combined profits at the nine money center banks would still have been above $3 billion.

Clearly, reductions of this magnitude do not represent a threat to the safety and soundness of the banking system; in fact, they do not even pose a threat to the profitability of the

nine most exposed money center banks. However, while this alternative policy would not have placed an onerous burden on the U.S. commercial banking system, the potential benefit to U.S. farmers and export manufacturers could have been quite substantial.

For example, debtor nations would have been under less pressure to expand their exports and less constrained to reduce their imports. For U.S. farmers, this would have meant an opportunity to increase U.S. agricultural exports to Latin America, the prospect of less competition in world export markets from Latin American producers, and the possibility that prices for U.S. farm products would be under less downward pressure.

It is important to point out that these changes would have merely slowed the growth of Latin America's wheat and soybean exports and moderated the decline of U.S. exports. Even after this change, U.S. exports would still be declining and Latin America's exports would still be growing. But the injury inflicted on U.S. farmers by the Administration's debt crisis policies would be reduced.

Example II

A second possible approach would entail limiting interest payments to a certain percentage of each debtor nation's export earnings and specifying that banks must write-down the value of their outstanding loans by a certain amount during every year in which Latin American debtor nations hit this revised interest

payment target. For example, the Administration could have advocated limiting Latin America's debt service charges to 25 percent of its export earnings and telling banks to reduce their outstanding principal by 1 percent during each year in which Latin American debtors pay this new debt service charge.

If implemented at the beginning of 1985, this policy option would have reduced Latin America's annual interest payments by $12 billion. And if the nine money center banks absorbed their proportionate share of this burden, their before-tax profits would have declined by $2 billion. After-tax profits would have declined by a little more than $1 billion. Although this sounds like a steep reduction, it would merely have slowed the rate of growth of bank profits. The combined 1985 after-tax profits at the nine money center banks would still have been above the 1984 level and only 14 percent below their 1982 level. Clearly, a reduction of even this magnitude would not have represented a serious blow to bank profitability.

In addition to slowing the growth of bank profits, this option would have reduced the annual value of the combined assets of these nine banks by $500 million, or 0.07 percent. However, as the Federal bank regulators at the Federal Reserve Board, Comptroller of the Currency, and Federal Deposit Insurance Corporation emphasized in their recent discussion of Financial Accounting Standards Board Rule 15, banks do not have to incur a charge-off merely because they have reduced the interest rate or the outstanding principal on a particular loan.25/ According to

Financial Accounting Standards Board Rule 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, concessions to debtors result in a charge against bank capital only when the sum of future principal and interest payments falls below the amount of principal outstanding at the time of the restructuring. Since the amount of debt service reductions envisioned in this option would not come close to reducing future payments to the level at which write-downs are required, this option would neither impair bank capital nor endanger the safety and soundness of the commercial banking system.

While the financial impact on the banks would not have been draconian, the benefits to the U.S. economy, and also to the commercial banks, would have been quite substantial. The share of the benefits accruing to the U.S. economy should be much larger than the share of the burden absorbed by U.S. banks. U.S. money center banks hold only one-sixth of all commercial bank loans to Latin America. But nearly 50 percent of the trade surplus that Latin America needed to pay interest was generated by reducing its purchases of U.S. products. This suggests that a $12 billion reduction in Latin America's debt service charges could have increased U.S. sales to Latin America by as much as $6 billion, while after-tax profits at the commercial banks would have declined by only $1 billion. In other words, the benefit cost ratio for the U.S. economy is approximately six to one.

These examples suggest that, in the future, some negotiated arrangement limiting debt service payments may be the best way to

avoid more radical, unilateral actions by Latin American debtors. During his July 1985 inaugural address, for example, Peruvian President Alan Garcia announced that his country would devote only 10 percent of its export earnings to interest payments. As the debt crisis continues to fester, with no permanent solution in sight, additional Latin American leaders might conclude that this sort of solution is the only way to restore growth and improve standards of living. If they unilaterally begin to limit their country's interest payments to 10 percent, or even 15 percent, of export earnings, the impact on bank profits, capital, and solvency will be even more severe.

Some sort of realistic assessment of the ability of debtor countries to service their debt holds out the promise of making an effective frontal attack on the debt crisis, in contrast to current policies which only postpone a permanent solution, add to Latin America's external debt, and leave the prospect of loan defaults and financial ruin hanging over the banks. If policies were to be adopted along the lines of the second example, Latin America's debt burden would begin to decline. And, in fact, after several years, if commodity prices start rising and interest rates stay at their current levels, 25 percent of the new, higher level of export earnings may be more than sufficient to pay debt service at the then-prevailing market rate of interest on the new, lower level of outstanding principal. Consequently, banks would resume earning a market rate of return and debtor nations could use the excess payments either to boost

their imports even more or to begin retiring their debt even faster.

Finally, the potential future costs to the banks and to the U.S. economy of not adopting alternative policies may exceed the costs to the banks of implementing these reforms. Current Administration policies offer Latin American debtor nations little hope that their debt service burden will be eased anytime soon. Consequently, the pressures on Latin American leaders to default or declare a debt payment moratorium could increase substantially. This, in turn, could force banks to write-down their Latin American loans by an amount that would impair their capital.

As capital declines, a bank's ability to weather losses on other portions of its portfolio also declines. In addition, the amount of loans it can have outstanding must also be reduced. In general, current regulations require banks to reduce their outstanding loans by $16 for every $1 decline in their capital. In other words, a write-down of Latin American loans could generate an unwanted and unhealthy domestic credit crunch. U.S. consumers and businesses would be deprived of credit. Many would face financial ruin. Upward pressure on interest rates could resume.

Alternatives to present policy could help to avoid this prospect. They might slow the growth of bank profits, to be sure, but, in return, a long-term solution to the Latin American debt crisis would be in place. And, just as important, the

solution would not require inordinate sacrifices by other sectors of the U.S. economy.

FOOTNOTES

1. Economic Commission for Latin America (ECLA), Preliminary Overview of the Latin American Economy 1985, Santiago, December 1985, Tables 12-15.

2. Department of State, Report to Congress on Foreign Debt in Latin America, December 1985, Table 4.

3. Ibid., Table 8.

4. This strategy is outlined by then-Treasury Secretary Donald Regan in Hearings on International Debt, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 4, 1983.

5. Department of State, op. cit., Table 6.

6. ECLA, op. cit., Table 7.

7. "U.S. Agricultural Exports Up 8 Percent to a Record $43.8 Billion in Fiscal Year 1981," Foreign Agricultural Trade of the U.S. (FATUS), U.S. Department of Agriculture, Economic Research Service, November/December 1981, p. 5.

8. For U.S. agricultural exports to Latin America in 1981, see ibid., Table 4. Statistics for 1985 are from "Increased Supplies Dampen U.S. Farm Exports," FATUS, November/December 1985, Table 6.

9. U.S. agricultural exports to the Soviet Union are detailed in "Increased Supplies Dampen U.S. Farm Exports," ibid., and "Soviet Imports of U.S. Agricultural Products Since the 1980 Sales Suspension," FATUS, May/June 1983, Table 1.

10. ECLA, op. cit., Table 10.

11. See Donna U. Vogt and Barry Carr, Patterns in Trade of Selected U.S. Agricultural Exports, Congressional Research Service, Report 86-510 ENR, January 30, 1986, Table 14.

12. Ibid., Table 17.

13. See "Undernourished Children," in Foreign Broadcast Information Service, Daily Report, Latin America, April 28, 1986, p. D1.

14. Statistics on recent bank failure rates are reported in Randall A. Killebrew and Michael Fitch, "Statement of the American Bankers Association on the Problems of Agricultural

Credit," Presented to the Committee on Banking, Housing, and Urban Development, U.S. Senate, March 6, 1986, p. 3.

15. See Emanuel Melichar, "Farm Financial Experience and Agricultural Banking Experience," Statement before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, October 23, 1985, Table 12.

16. See testimony of International Trade Commission Chairwoman Paula Stern, "The Soverign Debt Problem and its Impact on U.S. Foreign Trade," Statement for the Subcommittee on International Development Institutions and Finance, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, March 19, 1986.

17. Historical data on syndicated bank loan spreads is contained in Ricardo Ffrench-Davis, "International Private Lending and Borrowing Strategies of Developing Countries," Journal of Development Planning, No. 14, 1984, p. 142-143.

18. See ECLA, op. cit., Table 18.

19. Statement of the Honorable James A. Baker, III, Secretary of the Treasury of the United States, Before the Joint Annual Meeting of the International Monetary Fund and the World Bank, October 8, 1985, Seoul, Korea.

20. These projections are contained in Report and Recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Agricultural Sector Loan in an Amount Equivalent to U.S. $350 Million to the Argentine Republic, Report No. P-4161-AR, March 14, 1986, Annex VII, p. 2.

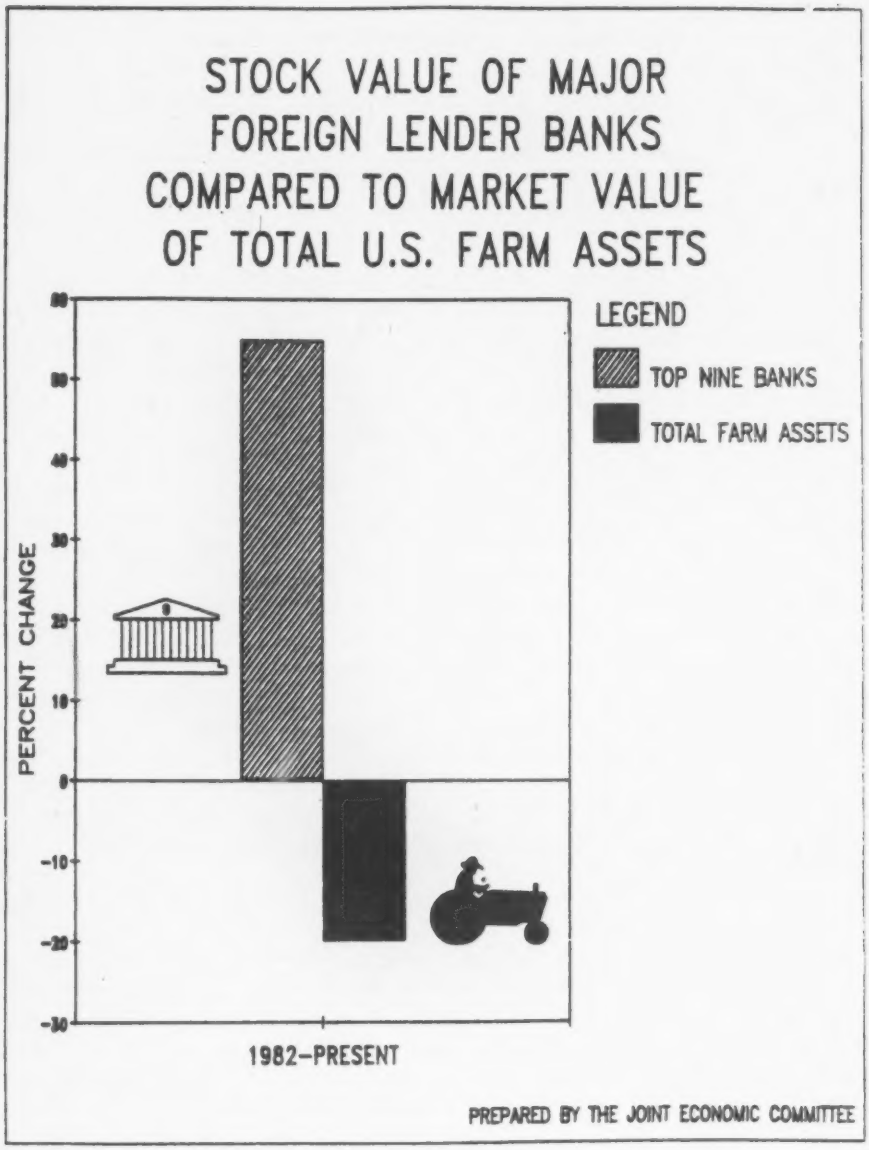
21. Ibid., p. 8.

22. Ibid., p. 9.

23. Ibid., p. 21.

24. Department of State, op. cit., Table 4.

25. See, for example, statement of Robert L. Clark, Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 11, 1986.


STOCK VALUE OF MAJOR
FOREIGN LENDER BANKS
COMPARED TO MARKET VALUE
OF TOTAL U.S. FARM ASSETS
LEGEND
TOP NINE BANKS
TOTAL FARM ASSETS
PERCENT CHANGE
40
30
20
10
0
-10
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-30
1982–PRESENT
PREPARED BY THE JOINT ECONOMIC COMMITTEE

Representative OBEY. Mr. Scheuer, do you have a brief comment before we begin?

Representative SCHEUER. No, I don't; Mr. Chairman.

Representative OBEY. Thank you.

Mr. Bailey, why don't you proceed either to deliver your statement or summarize it, whichever you would prefer?

STATEMENT OF NORMAN A. BAILEY, FORMER SPECIAL ASSISTANT TO PRESIDENT REAGAN FOR INTERNATIONAL ECONOMIC POLICY

Mr. BAILEY. Mr. Chairman, Mr. Scheuer, before beginning my formal testimony, I would like to say it's a particular pleasure to appear before this committee because of the work that this committee has done, in my opinion, in a very constructive way on the international debt crisis, and the recent staff study which I think for the first time in a major way woke up many groups in this country as to who is paying for the debt crisis.

We did some calculations in February 1985 when I testified before the Latin American Subcommittee of the House Foreign Affairs Committee in terms of who paid for the debt crisis, and at that time it was our conclusion that, aside from the debtor countries, the organisms that had been primarily responsible for paying for the debt crisis had nothing to do with the debt crisis itself and those were the productive sectors of the creditor countries—the industries, the agriculture, the workers and so on—and that the debt crisis had cost them in the first 3 years $108 billion.

We redid those calculations recently and concluded that in the first 4 years the debt crisis had cost the productive sectors of the creditor countries $140 billion. They were not responsible for the crisis at all and yet they were one of the most important sectors which was paying for it.

It's doubly a pleasure to be here today because the other person testifying is my good friend, Bob Lorenz, who is one of a handful of American bankers who recognized the nature of the international debt crisis from the very beginning. Both he and I were reviled in our respective circles for indicating that we were faced with a systemic and structural problem that required a systemic and structural response that it was not getting, and that the way in which the debt crisis was handled was going to make the crisis progressively worse rather than better, and I think that despite the fact that some of our traditional adversaries still refuse to admit that the Sun rises in the east and sets in the west, the facts of the case have amply borne out the correctness of our diagnosis.

Mr. Chairman and members of the committee, 8 months have now passed since Treasury Secretary Baker unveiled his LDC debt initiative at the annual meeting of the World Bank and the IMF in Seoul, Korea. In summary form, the Baker initiative consisted of three parts—a much more active role for the World Bank and regional development banks, additional net lending by the commercial banks over the next 3 years, and so-called developmental or growth reforms by the debtor countries themselves.

Of the three parts, only the first has been partially implemented with new programs and enhanced lending by the World Bank. Why have the second and third parts stymied?

One possible explanation is that the plan is caught in a classic chicken or egg situation. The commercial banks demand that reforms be credibly implemented before they will lend more—the debtor countries, on the other hand, want assurances of the additional funds first. In addition, many commentators have suggested that the proposed additional bank lending of $20 billion over 3 years is insufficient.

Another explanation, the one to which I subscribe, is that the incentives offered to the debtor countries to make difficult and politically dangerous internal reforms are simply insufficient. Many observers, official and unofficial, in both debtor and creditor countries, are reaching the conclusion that for the debtors to take on additional debt, whatever the quantity, is simply the wrong thing to do. What the majority of debtor countries need is not more debt, but debt service relief. The commercial banks themselves, by their passive resistance to implementing the Baker plan—despite verbal support—seem to be tacitly agreeing with this analysis, and more and more commercial bankers are openly agreeing with it.

Debt service relief can be provided either by applying a lower than market rate of interest to the existing stock of debt or by accepting a fixed percentage of debtor country foreign exchange earnings for payment of interest. The differential may or may not be added to the principal to be repaid later—that is, "capitalized." In order for the commercial banks to make such a concession in the case of the huge quantities of debt we are dealing with here, they must be able to write down the value of their credits over a period of years rather than all at once. Unfortunately, given the present regulatory climate, that is exactly what they have had to do, which has also put great pressure on the regulators not to "classify" loans obviously worth much less than par. Certain foreign banks, especially those of continental Europe, have been engaging in such gradual writedowns for years and are consequently in much better shape than most major U.S. banks. They have done this, however, without making any concessions to the debtor countries.

In March 1986, however, the three principal bank regulatory agencies, the Federal Reserve, the FDIC and the Comptroller of the Currency, announced their intention of activating the provisions of Statement of Financial Accounting Standards No. 15 to provide breathing room for the banks heavily exposed to domestic agricultural and energy loans, which represents about $110 billion of questionable debt. The application of rule 15 would enable the banks to adjust to the reduced value of their assets over a period of 7 years or even longer, rather than overnight. This congressionally welcomed initiative toward the kind of flexibility banks in other countries have had all along requires no congressional action and can perfectly well be applied to the foreign exposure of U.S. banks as well, thereby enabling them to agree to below-market interest on the existing stock of debt or other concessional terms. Indeed, it is hard to imagine how similar treatment would not be extended to the banks' LDC exposure, especially given the increased debtor solidarity demonstrated at the Punta del Este meeting of the Catagena

Group. For the first time since the debt crisis erupted in 1981 and 1982 a true solution to this systemic and structural problem can now be envisioned.

This initiative on the part of the regulators should be vigorously supported and its extension to external loans be actively encouraged. In this way perhaps a sufficient incentive can be offered to the debtor countries so that they will take and vigorously implement those measures of internal reform so badly needed and so essential for their eventual return to prosperity, growth, and creditworthiness.

Other strategies could also be considered, such as a compensatory funding facility for interest rates in the IMF, which then could regain a central role in the process; or obligatory relending of 50 percent of the interest that the commercial banks receive, to the world and inter-American banks, which would then lend it to the debtors as structural adjustment and project loans. Something similar is now done for Poland; 60 percent of interest received is reloaned to Poland in the form of trade credits.

Or permission for the banks to convert—directly or through a new institution—their exposure to long-term, fixed-rate 5 percent coupon bonds, with special discount facilities at their central banks if liquidity is seriously threatened.

It would appear, Mr. Chairman, that Mexico will be the country which will test our imaginations and will again, as it did in 1982.

Mexico's original debt strategy for 1986, which sought $2.5 billion in private creditor loans and $2 billion in World Bank and IMF credits as means of efficiently servicing its external debt, collapsed in January when oil prices began their sharp decline.

That development caused the Mexican Government to revise its debt strategy while simultaneously devising an oil strategy aimed at cutting its oil revenue losses. From February through April, pending a resolution of its debt and oil initiatives, the Mexican Government avoided any commitment to drastic domestic economic adjustments aside from those already written into the 1986 budget.

During the February-April period, Mexican efforts to secure interest rate concessions from its private creditors and commitments to more than its original $4.5 billion, 1986 credit needs floundered, and government efforts to facilitate an OPEC/non-OPEC oil exporter agreement on petroleum production quotas also failed.

As a result, since early April, the Mexican Government has initiated a series of gestures aimed at impressing its private creditors and the IMF with the objective of securing a new IMF-sponsored stabilization plan that would restructure $4.5 billion in principal payments due in 1986, advance a new IMF facility for Mexico and clear the way for new private loans to Mexico. Thus, in April and May, the government announced a plan to cut budget expenditures by $1 billion, reduce subsidies for tortillas, put up for sale government shares in some 102 government subsidized corporations—if sold the government would save $230 million in subsidies—refused, at least for the present, to support a rise in the minimum wage, and the government is still negotiating its way into GATT despite GATT member demands for a major overhaul of Mexico's tariff system.

Negotiations with the IMF which stopped in the wake of the oil price drop have been renewed, and it is likely that to satisfy the fund and the country's private creditors, a whopping austerity program will have to be authorized by the government.

If enacted, such a program would drive the Mexican economy back into negative growth—after it grew by 4 percent in 1985. The inflationary growth of the first half of 1985 began to slow in the second half, and it was anticipated that the 1986 austerity budget announced in November would drive 1986 growth down. But most forecasters, who foresaw 2 percent GDP growth for Mexico in 1986, based their forecasts on government failure to live up to budget deficit and inflation targets set in the original 1986 budget plan, announced in November 1985.

In that budget the inflation target for 1986 was 45 to 50 percent, down from 65 percent in 1985. However, in the first 2 months of this year, cumulative inflation was 13.2 percent, suggesting an 80 percent inflation rate. With petroleum prices collapsed, Government revenues will fall by 12.5 to 15 percent for the year. The 1986 budget targeted the Government deficit to be 4.9 percent of GDP—a figure which no one believed would be met and which was principally offered to pacify the IMF and private creditors. Now with oil prices battered, the deficit will minimally be 10 percent of GDP and could be as high as 12 percent. If it hits at that level, inflation will be higher than in 1985, perhaps reaching 100 percent in 1986.

The April-May budget cut announcement of $1 billion is only a drop in the bucket for what would be needed to pacify the IMF. Some experts say that the Government's new austerity package will include $2.5 billion in new cuts and could be as high as $3.7 billion. It is believed that cuts close to the latter figure will be needed to satisfy the IMF. However, the likely inability of the Government to live up to the cuts, especially with important State elections later this year, will put Mexico out of compliance with any agreement likely to be reached with the IMF.

Either failure to come to terms with the IMF or failure to comply with IMF targets would probably provoke a payments crisis for Mexico later this year. Last year, the country's reserves dwindled by a large 46 percent and the Government entered this year with only $4.4 billion in net reserves. With only small amounts of World Bank money coming during the first 4 months of 1986, Mexico must have severely drawn down reserves—$4.4 billion is equal to 4 months of imports.

The oil price collapse has sent Mexico's oil prices down to $10 to $11 a barrel and depressed production from 1.5 million barrels a day in 1985 to 1.1 million in 1986. At $15 a barrel and 1.5 million barrels a day production, Mexico loses $6.24 billion in export earnings. Thus, with prices and production lower, 1986 losses could go as high as $8 billion or more.

Total projected 1986 Mexican export earnings were $22.6 billion, a figure calculated including a dubious 10 percent growth in nonoil exports, which would have represented about $1 billion. Considering the depressed nature of the country's nonoil export markets in the United States and the fact that in 1985 a projected 10 percent growth in nonoil exports turned into a 10 percent contraction, 10 percent growth for these exports in 1986 seems unrealistic. Thus,

total 1986 exports of maximally $14 billion is likely in 1985. Mexico's imports totaled $14.4 billion in 1985. The original austerity budget targeted imports at $13 billion, or $1.4 billion below 1985. This would leave a trade surplus of $1 billion in 1986.

Mexico's interest payments for 1986 were first estimated to be $10.1 billion. The decline in interest rates has lowered these payments by $1.5 billion, down to $8.6 billion. Mexico is also scheduled to pay $4.5 billion in principal during 1986.

Thus, Mexico would fall $7.6 billion short of servicing its 1986 interest payments and $12.1 billion of total debt service. In February, when things did not look this bad, Mexican officials were talking about needing $8 to $9 billion in new credits this year to service the nation's debt. Silva Herzog traveled to Washington in later February after de la Madrid went on national television on February 21 pressing Mexico's case for interest rate relief in light of the oil price collapse. Silva Herzog met with United States Government resistance from Baker and Volcker to the doubling of Mexico's credit requirements; they asserted that the country did not need additional finances to service its debt, but could generate what was needed through internal adjustment.

At this point, the Mexican Government lowered its request to $6 billion. Before Silva Herzog once again traveled to Washington to deliver these revised figures in early March, the Punta del Este meeting of the Catagena group was held with the principal objective of enhancing Mexico's bargaining position with the United States Government, the IMF, and private creditors.

The new $6 billion figure was arrived at by lowering Mexico's imports by another $1.5 billion—to $11.5 billion—increasing nonoil exports another $0.5 billion, and eliminating plans to boost reserves by $1.2 billion in 1986.

U.S. officials told Silva Herzog that real signs of efforts to cut the Mexican budget and restructure its economy would be needed to satisfy the IMF and open the door for a new negotiated debt stabilization package.

By the end of March, Silva Herzog publicly reported that efforts to obtain interest relief below creditors cost of funds was unreasonable. He then reported that Mexico would only ask for $4 billion in new loans. The $2 billion difference between the old and new request is accounted for by a Mexican proposal that the United States agree to import $1 billion more of Mexican exports in 1986—that is, the United States give Mexico preferential trade treatment—and that $1 billion in interest payments to the Paris Club due in 1986 be deferred. The former proposal was made to U.S. officials in early March.

Silva Herzog has subsequently floated other schemes that would, in effect, lighten Mexico's interest payments load for 1986—a more palatable form of the Peruvian approach that would not ask for interest ratio relief below creditors cost of funds.

Currently IMF-Mexico negotiations have reached an impasse and with a large drawdown of reserves since oil prices began to plummet, Mexico's ability to service its debt has come into question with payments due in mid-June and early July. Mexico will, if it meets these payments, be forced to dig deeper into its reserves. Clearly, in the short term, Mexico's reserves will run out and the country will

once again face a payment crisis. As that prospect moved into sharper focus, an avalanche of rumors have emanated from Mexico City suggesting that the government may move to take preemptive action on the debt issue. Some form of debt moratorium or other means of effectively reducing Mexico's real debt service payments are heavily rumored to be in the offing and with these rumors in combination with the prospect of a payments crisis the peso has rapidly depreciated as Mexicans desperately seek to exchange pesos for dollars. This development only exacerbates Mexico's precarious reserve position.

All this statment was prepared, of course, prior to Silva Herzog's resignation.

These possibilities now loom for Mexico's handling of its debt crisis:

Preemptive action in the form of a limited debt moratorium or other mechanism effectively lowering debt service payments followed by intense negotiations with creditors, creditor governments and the IMF.

A payments crisis in which sometime this year, Mexico, its creditors, creditor governments and the IMF work on an emergency basis to temporarily stabilize Mexico's external finances.

Looming less likely at present is an IMF agreement which would temporarily postpone the crisis at the price of an unrealistic Mexican austerity program which will see the nation's economic performance fall out of compliance with IMF targets before the end of the year. Under these latter circumstances, Mexico will likely experience −4 percent growth in 1986, 90 percent inflation, and a budget deficit reaching 10 to 12 percent of GDP.

Those figures are the most likely results of Mexico's failure to live up to the targets later this year of any agreement that might be acceptable to the IMF. Mexico might avoid falling out of compliance if it were able to keep its budget deficit below 9 to 10 percent of GDP and inflation below 70 percent. If these targets were to be met, however, Mexican growth would likely contract by −5.0 percent or more in 1986.

A limited debt moratorium or payments crisis could also have the effect of significantly impacting Mexican growth, inflation and budget deficit performance in 1986, most likely in a negative direction in all three areas. However, a limited debt moratorium, if it does not generate negative financial reactions internationally and domestically, could improve the growth picture for Mexico in 1986.

Thank you, Mr. Chairman.

Representative OBEY. Thank you very much, Mr. Bailey.

Mr. Lorenz, why don't you proceed with your statement before we ask questions.

STATEMENT OF ROBERT M. LORENZ, SENIOR VICE PRESIDENT (RETIRED), SECURITY PACIFIC BANK, LOS ANGELES, CA

Mr. LORENZ. Thank you, Mr. Chairman. I also want to thank you and your staff for this opportunity to present my lonely dissenting banker's views on the debt problem and also to compliment you for your study. I thought it was lucid, well documented, very clearly written, and an important contribution at this point in time. If you

had done it 1 year ago or 2 years ago, it would not have the impact that I think it will have now.

My credentials for speaking to you are 31 years of experience in living in and lending money to all of the Latin American countries, and specifically that we appear to be the only major bank in the world to have seen a problem coming in Latin America. We underestimated the magnitude of the problem but we did see a problem coming at the time of the second oil crisis and coincidentally for Mexico at more or less the same time, and took a defensive position, which is why you do not see Security Pacific Bank's name on the list of banks with excessive exposure. We are today not a threatened bank as a result of the unpopular position we took in January 1980, 2½ years before Silva Herzog went to the New York Fed and announced Mexico could not pay.

I have some very strong views on this problem. We were in a difficult position at that point in time because our policy was to support the bank's steering committees that were formed to negotiate the restructuring agreements with each country. At the same time, we disagreed with the underlying premises that they were making in doing that.

We did not want to be a rebel bank and I did not ever speak to any other U.S. bank. We could easily have led a rump group of banks that opposed what was going on. That would have been destructive to the problem.

The emergency that occurred in August 1982 was a very serious one and I give Mr. Volcker a great deal of credit personally for handling an emergency at that time the dimensions of which no one really knew. It's easy now to sit back and criticize it, but at the time I thought he acted—I think we were on the verge a week after the Mexican announcement of a 19th century financial panic, and I think only Mr. Volcker understood that and was effective in containing the problem. Perhaps you don't remember, but a week after Silva Herzog made his announcement there was a rumor that went out over Reuters that a major New York bank was closing its doors because of its exposure in Mexico. Within half an hour, no bank could sell a CD, no bank could fund itself in the marketplace, which in the eyes of the Fed is the worst—it's Armageddon—it's the worst thing that could possibly happen.

He understood that that was a major problem and when it did happen he moved effectively to block it. So, I give him a great deal of credit.

At the same time, in the heat of the emergency that existed, the debt problem was defined on this side of the border unilaterally by the financial center banks and the IMF as a short-term liquidity problem. I don't have any problem with that except that in March 1983 in a meeting with my senior management and subsequently with our board we decided that that was not a proper definition, that we were, in fact, talking about insolvency.

Now, I'm using banking terms and just to give you an example, if General Electric comes in today and says, "Lorenz, we can't make the $10 million payment that we owe you next Tuesday. We need it to be refinanced for 180 days," that is a liquidity problem and we would say to General Electric, or whoever, "Well, OK. You have been borrowing from us at the prime rate. You're now going

to pay us 2 percent over prime, and we're going to charge you a $50,000 fee for refinancing this $10 million payment that you can't pay."

If we were dealing with an insolvency, as was the case with International Harvester, then in banking terms that's a very different problem. A bank would normally reduce the rate of interest and would never charge any fees. You would have to write off. You would have to do whatever your credit committee decided to do, but that was how you would basically approach those two definitional problems.

And so that's why the definition of the problem, which is still defined as a short-term liquidity problem—well, maybe not quite, but it has kept that definition throughout the last 3½ years, and it's very important because in addition to just simply being wrong, demonstrably wrong, it has finessed all of the imagination and innovation that should have been applied to this problem.

Although we changed our opinion in March 1983, we could accept that definition for the first year. But after the summer of 1983, the very fine minds that we have in this country with marvelous educational credentials should have been looking at the problem from a fresh point of view. We should have gone back to square 1 and done something definitive with the problem, which we did not do and are still not doing.

So, I have some objectives I think that are stated in my prepared statement. We should get the debt problem off of center stage and let these countries go about trying to restructure their economies and handle the very serious, economic problems that they intrinsically have. As long as the debt problem is there befuddling everything, commanding all kinds of time and attention by everybody in these countries, their internal, domestic economies are deteriorating at a very fast rate.

We should restore some degree of confidence in the people of these countries to attempt to stop and hopefully reverse the capital flight. That's become an extremely serious problem all through Latin America even reaching the point in Argentina where the capital flight took the form of Argentines dismantling their industrial machinery and shipping their plants to Brazil. To my amazement, that happened last year and was a factor in Brazil's improved current account surplus, if you can believe that kind of goings on.

And also, finally and importantly, to maintain the integrity of the American banking system and the confidence of the American public in its banking system.

Representative SCHEUER. The confidence of the American public in what?

Mr. LORENZ. That the debt problem is getting better, restore confidence in the public in each country.

Mr. BAILEY. In the American banking system.

Mr. LORENZ. I'm sorry. Maintain the integrity and confidence by the American public in our banking system. In other words, not take any action, no matter what the feelings in Congress might be, that would really destroy or create a crisis of confidence around the American banking system. I saw that happen in Argentina in 1980 when 50 banks went under, including the 3 largest, and the

country is still paying the price for that. I think it will be two generations of good government and stability in the country before they can recover any degree of confidence because of the banking crisis.

So anything that would tend to erode that is a very dangerous thing to do and a very negative thing to do in any country.

But the first point that I want to make is that this unilateral definition of the debt problem as a short-term liquidity problem on this side of the border by the financial center banks and the Monetary Fund is wrong. We are 3½ years into the problem. Nobody has received any payment of principal. We have had to lend the money in order to make them pay interest. So while we can pretend that it's short term or we can deal in semantical fine points on the question, it's 3½ years and nobody has received anything. So it's not short term.

The countries, when they got—and you have to remember that at the time the debt crisis happened we were in a transitional phase politically in almost every Latin American country, changing from military governments to civilian governments. When the civilian governments took office—I've had six different Latins from six different countries tell me that they were shocked beyond belief when they took power and understood how serious the debt problem was in each of their countries.

So they then began to develop their own definition of the problem and this was expressed repeatedly by delegations coming to Washington and New York and talking to our Government officials and the financial center banks, and they said—and I know some of these people who have been doing this—they said very clearly, "We can't pay." Now they said that flat out in private repeatedly.

The problem seems to be that we don't listen when we are told these things or things that we don't want to hear from people like this, and so nothing happened.

Then they formed, as you know, the Cartagena Group of countries and in one voice they said as loudly as they could, "We can't pay. And moreover, our definition of the problem is that it is a long-term problem; it is a political problem; and our economies must grow at 5 percent if we even hope to be able to service a portion of our debt."

It had no impact up here whatsoever. None. So I don't know what you do. Certainly I, as a banker, if you come into my office and say, "Lorenz, I can't pay you the loan I owe you," I'm not going to just look blank and tell you to go away. It indicates a clear need to sit down and do something about that position, either demonstrate to them that they were wrong or structure something that implies some kind of a workout.

But again, that wrong definition has done the most damage by simply brushing aside all of the imagination and innovation that various people have tried to apply to the problem—Felix Rohatyn, and Lord Lever, and your own committee more recently.

I felt in this regard that the Baker proposal conceptually was the first breath of fresh air, the first positive development on the debt problem in 3 years, when he made it last September in Seoul, Korea, because it seemed to accept the country's definition of the problem.

If you and I have a problem and we can't define what the problem is, we're not going to be very successful in arriving at a solution. And that's the situation that we essentially have had.

The Baker proposal said, "Yes, it's a long-term problem. Yes, your economies have to grow in real rates of growth in the future." And he said that, "the official sector, the World Bank and the various finance ministries in the developed countries, have to become more directly involved in handling the debt problem."

That, in my opinion, was a de facto recognition of the political nature of the problem because in the past the countries were told, "Don't come and talk to the State Department or to Treasury or to anybody up here. It's a problem between you and the IMF and the New York creditor banks." It isn't. It is a political problem and you will see I think very shortly—well, you're already beginning to see what is happening.

We have a fallout from this problem by the fact that the thinking up here has been so rigid, and inflexible, and so diametrically opposed to the position that the countries have taken. We have created at least a partial vacuum, and the partial vacuum is being filled in a very threatening way by the borrowing countries.

You had Alan Garcia, the President of Peru, say, "We are only going to pay 10 percent of our export earnings to debt service." Now all of that 10 percent is going to the Paris Club or the industrial country government-to-government debt. None of it is coming to the commercial banks from Peru.

You have had Dilson Funaro, the Finance Minister of Brazil, just recently say to the governments—he's not saying it yet to the banks, but he's saying it to the Paris Club governments, "We are only going to pay you 15 percent of our government debt over the next 15 years with a 4-year grace period." In other words, no payments for the next 4 years. "When we sent you a check, if you want to"—and I'm paraphrasing what he actually said—"When we sent you a check, if you want to return it, that's perfectly all right."

From a banker's point of view, that is something that you never let happen. You never let International Harvester dictate what products it's going to make, who's going to manage the company, when it is in bankruptcy. That becomes a negotiation in which the bankers, who really own the company at that point in time and the creditors who really own the company, have an awful lot to say. The worst possible set of circumstances is to let the borrower dictate to the lender what is going to happen.

Because of our inability to arrive at a common definition leading into a negotiation, we are now creating a vacuum in which you are going to see more and more countries taking unilateral action on their own without any negotiation really with anyone. And I think Mexico is probably the next country in line and that's going to be a fire storm when it happens.

Second, the magnitude of the debt problem is the most compelling single factor in it. If Mexico had a $50 billion debt, then the traditional IMF agreement would work. The fact that we are trying to force a $100 billion debt through a gross domestic product of $170 billion in essentially a short term is just not possible. It is for

that reason that in early 1983 we decided that we were really looking at an insolvency and a long-term problem.

The term of the problem varies from country to country. It's hard to generalize on it. I think some of the stronger countries like Brazil have a medium-term insolvency, and some of the weaker countries have a long-term insolvency. But you just have to look at the ratio of debt to GDP on this. The banker's rule of thumb is that a sound country—its ratio of debt to GDP is that the debt is no more than about 20 or 25 percent of its GDP. In Mexico, it's 60 percent. Chile has a debt of $22 billion and a gross domestic product of $18 billion. It's 120-odd percent in Chile. There is no way the Chileans are going to be able to pay that debt. Fifty years from now they will still be struggling with this debt problem.

So those are examples. Brazil is in a stronger position with about 40 or 45 percent. Argentina is around 70 percent. They can't handle that in the short term and they should not really be asked to.

I want to qualify what I'm saying. I am not implying that we give away the store to the countries. If they have to be in a 10-year adjustment program, then that should be carefully monitored, I believe, by the World Bank because the World Bank has a long-term mentality as opposed to the basic character of the Monetary Fund which is short term. But they should be kept under close supervision as the banks would with any domestic borrower who gets into trouble until the domestic borrower's credit standing has returned and its debt is considered current again.

In considering the magnitude of the debt, I want to say that it is the utmost folly to be increasing the debt. Behind all of these problems are human beings and there is a psychological dimension to the problem that cannot be overlooked, and that, as you see, is the major consideration in the capital flight that occurs from each of these countries. And the capital flight is just incredible.

I think the Argentines easily have foreign assets in an amount in excess of their $50 billion debt. The Mexican number is harder to come at, but I would subscribe to one analysis that shows that it's $64 billion. But it goes beyond that. The Mexican upper class is sending its children to this country. The capital flight is taking a human dimension. Not only do they have assets up here, but they're sending their children up here to manage those assets. I have two Mexican friends each of whom have a child who has been sent to the United States and who has announced to his family that he is taking out United States citizenship and will not return to Mexico. That's a terrible tragedy when that kind of thing happens, or when the Argentines send their plants abroad. These countries should not be pushed to the point that that kind of thing goes on.

But psychologically, increasing the debt is the folly. There is no banker that I have talked to who believes that increasing the debt has improved the creditworthiness of any of these countries. If you were to go talk to the man in the street, go over to Mexico and talk to any Mexican at any level and ask him if he thinks that the debt problem which began at $84 billion in 1982 has become better as it has gone from $87 to $94 to $98 to $100 billion.

And so what has happened? When the $6 billion bailout was announced, you had an immediate resurgence of capital flight from Mexico. You had had capital inflows into Mexico during the early months of this year, but when the bailout was announced a couple of weeks ago, you had an immediate drop in the peso and an immediate flight of capital out of the country. The Mexicans will pay any rate at all.

My third point is that the Latins, unlike the Asians, have used the Eurodollar as their source of development capital, of capital investment in their economy. Since the 1982 problem began, they have been precluded from borrowing in the Eurodollar market. This means that their only source of capital is from their exports, and this is why their need to export in the traditional IMF program—export more and imports less—is having such an impact on our economy here and continues to have an impact.

Their only source of capital is what they can generate through domestic savings with the people that have no confidence in their economy, with high rates of inflation, so domestic savings are miniscule in every country. So, really their only source of capital to invest in their economy, to provide jobs, is through their exports. And this is why you are seeing the political leaders in each country taking the position that "We're only going to pay you x percent of our export earnings because that's all we can afford, given the fact that we have to make our economy grow at 5 percent or 6 percent or 4 percent or something." They have to have capital investment to do that.

Mexico is a critical example of this. The Mexicans need to create 1 million new jobs every year to handle new job entrants. They have gone almost 4 years now with no jobs being created, none. So, they are 4 million behind. Plus the austerity program that they had to go through during this period of time has substantially reduced employment and increased underemployment. So, how long can this go on? And if you were the political leader of Mexico looking at this problem, what would you do? There's only one answer in each of these countries. And that is, that they will unilaterally, if there is no other option, do what Alan Garcia of Peru has done, and that's limit the amount of debt service that they are willing to give to the foreign lenders.

The last point that I want to make and really my most important point is that for some unexplained reason the lenders up here will not even entertain the thought of writing off. I should say that I use the term "writing off" when I really don't mean that. I mean taking reserves against these loans, but it really is the same thing. It's just a question of timing. It's an accounting problem and a timing of an accounting problem.

No bank in its right mind would say that if we have a problem with our farm loans that we're not going to have to write off some of those loans. We wouldn't say that with high-technology loans or with energy loans or with Master Charge loans or anything else.

But when a country borrows, for some reason, all of the traditional banking principles which have served banks for hundreds of years are thrown out the window and we say, "We can't even consider writing off any of these loans."

Well, if you have borrowers who are overborrowed and the magnitude of the problem is really what compels the problem, then you have a confidence problem because you're increasing the debt and not decreasing it, and thereby restoring confidence. Then it would seem logical and it would seem that the interests of the countries, the borrowers, and the lenders would coincide and that, yes, the lenders would be willing to write off some of the loans.

Now, I can understand how this could not happen in 1982. The banks were in a weakened position because of domestic loan problems. But in 1986 it's different. And I have provided some very superficial numbers that indicate that if this problem is managed properly—and Norman Bailey spoke to the point of this accounting principle 15 and the farm loan problem—that this problem can be managed. I think it's going to have to be done over 10 years. I think that one-third of the regional debt of $380 billion is going to have to be written off; $140 billion of that is government to government and $240 billion of that is international banks. One-third of each is going to have to be written off.

Now that works out in a global way to $30 billion to the U.S. banks over 10 years. That's $3 billion a year. Even when you look at banks with concentration in Latin America, you can manage that so that they would not have to write off in any of those years more than about $70 or $80 million because, remember also, that when we speak of writing off, we're only talking about the government medium- and long-term loans. We're not talking about any short-term loans nor are we talking about any bonded indebtedness which Mexico has and Brazil has and so forth.

This is not a problem that is so awesome or destructive to the American banks that it cannot be considered. I cite some examples. An accommodation was made to the banks with real estate investment trusts problems in 1976. That created a precedent. The more recent precedent with the farm loans and the accounting principle change that had to take place is a much better example. The Comptroller has a mechanism that was passed a couple of years ago with the IMF funding bill titled "Allocated Transfer Risk Reserve" which permits the Comptroller to specify the percent of each bank's loans to a specific country that the banks have to write off each year. For example, with Bolivia it started off at 15 percent in the first year and was 25 percent the second year. So he could say the banks have to write off 1 or 2 percent of Brazil's loans or 3 percent of Mexico's loans in the first year or whatever. That could be done. That could be managed in a way that would not unduly damage or hurt any of the major banks and it would serve the purpose of reducing the debt, not increasing the debt. It would also help I think to begin to restore a degree of confidence in the people in each country.

I have a couple of other points here.

On the question of writing off, the European banks have said quite openly that this is an American bank problem. They say that because, according to what we've been able to find out by making inquiries, the European banks have taken hidden reserves at the end of 1985 that amounted to 60 percent of their gross total outstandings to Latin America. They did this very quickly. Now that's an average number. It varies. The countries involved were France,

Switzerland, Germany, England, and Belgium and I believe Holland. But they, on the average, have taken reserves amounting to 60 percent. The Japanese banks are somewhere—it's a harder number to find out from the Japanese banks, but it's probably between 40 and 45 percent, with more being taken of course by both sides this year. So it really is an American bank problem.

One other point. On this question of the Mexicans, they can put out and do put out, when they're given a chance, a very plausible argument that they have done a lot to adjust. I'm not sure it's enough myself, but I do think that they should be listened to.

For example, they will say, on an inflation-adjusted basis, their budget is not in deficit, that they are not running a 13 percent peso budget deficit, they are actually in surplus. Well, what does that mean? The real world is you have inflation and they are in nominal pesos in deficit, no matter what they say.

But more importantly, the reserves of the Mexican banks, the peso reserves they have to keep, are 100 percent of their deposits. We have to keep 15 percent in this country and we have free use of the remaining 85 percent of our deposits. The Mexican banks must give all of their money to the central bank to finance the peso budget problem that they have.

But if you take out the interest payments on that peso debt, the Mexican Government as a percent of GDP has dropped from 30 percent in 1982 to 19 percent in 1985. That, in a central state Latin status kind of government is a major change. So they should be given credit for that specific point.

Thank you very much.

[The prepared statement of Mr. Lorenz follows:]

PREPARED STATEMENT OF ROBERT M. LORENZ

First, I want to thank the members of the Committee and its staff for this opportunity to present my dissenting views on the debt problem. My credentials to speak to you are, briefly, my thirty one years of living in and lending to the Latin American countries and the fact that my Latin American unit at Security Pacific was the only similar unit in any major bank in the world to see a problem coming, which we did at the time of the second oil crisis and for different reasons in late 1979 in Mexico.

Nothing I say is intended to let the countries avoid a long period of adjustment, preferably under the guidance of the World Bank.

OBJECTIVES:

—Get the debt problem pushed off center stage in a definitive way so that future economic shocks will not cause it to reappear and the countries involved can address the serious structural and economic problems they face.
—Restore some degree of confidence in the people of each country by reducing, not increasing, the total debt.
—Maintain the integrity of and confidence in the American Banking System.

I want to make the following four points;

1. The unilateral definition of the crisis by the financial center banks and the IMF as a short term liquidity problem that must be resolved by each debtor country in individual negotiation with the IMF and the bankers is demonstrably wrong. While this definition served to contain the crisis in the beginning and could be defended for the first year, we at Security Pacific concluded in March of 1983 that we actually had a medium and in some countries a long term insolvency that in the end would cause grave structural problems in each country and finally would require that a portion of the loanswould have to be partially written off by the foreign banks and governments.

The definition in banking terms is important. When any bank customer has a true liquidity problem, he can expect to pay a higher rate of interest and a sizable fee for any loan that must be refinanced. With an insolvency, however, banks normally reduce interest charges and never apply any commissions or fees.

The unilateral nature of the definition by this side has also caused serious problems with the countries involved. When the civilian governments finally took office in the Latin countries and began to look at the problem, they quickly came up with their own definition expressed in the Cartagena Group and elsewhere: long term, political (i.e. subject to government to government negotiation, not debtor government to foreign

banks) and most important they insisted on the need for their economies to grow in real terms. By my reckoning minimum real growth must be 5%.

The wrong definition in the beginning has finessed the need to look at and apply imagination and innovation to the problem. This is why the Baker proposal was such a breath of fresh air. It appeared to accept the country's definition. A common definition of the problem would seem to be the first step in its solution. It is perplexing that no one has picked up on this fundamental change and used it to produce a new direction and a more productive rationale.

2. The magnitude of the debt in each country is the single most compelling factor. The reason the traditional IMF programs have failed is that it is impossible for any country to adjust enough in three years to reduce its huge debt to amanageable level. There is no way the Mexican GDP of $170B can handle a debt of $100B (the debt to GDP ratio is 60%!). There is no way Chile's GDP of $18B can handle a debt of $22B (122%!). A banker's rule of thumb,which has certainly been verified in the past three years, is that debt to GDP should be no more than 20/25% in a sound country. It is this fact that even at todays reduced interest rates makes it impossible for the countries to pay the interest on their debt and still grow at adequate rates.

Psychologically, increasing the debt is folly. The man in the street in Mexico will never believe that a problem that caused such suffering in 1982 at $84B has gotten better at $106B; hence the renewed capital flight when the $6B bail out was announced.

3. The Latin countries only source of capital in today's world is their exports. They are precluded from the Eurodollar market and they have lost billions of dollars of short term bank credit lines and more billions of supplier credit lines. They are suffering from serious disinvestment through flight capital and loss of confidence by their private sectors. In my view this validates Alan Garcia of Peru applying no more than 10% of export earnings to debt service. While we may quibble about the percentage, the concept is sound. Your Alfred Watkins in his paper proposes an interesting solution based on 25% of export earnings. As a banker, I want to see their economies grow at a real rate of 5%. To do this substantial capital investment is needed. My loans will not be current, nor will I have any chance to recover any loans written off until the basis economy in each country is sound and growing at an acceptable real rate.

4. My final and most important point is to rebut the prevailing money center view that none of the country debt can be written off. Granted this could not have happened in 1982. But today the banks are in a stronger position with fewer domestic loan problems and therefor able to take some losses with their foreign loans. It all depends on how the problem is managed. To support this view the following factors should be considered:

A. In 1976 the Fed, FDIC, SEC, Comptroller and the seven accounting firms changed regulations and one accounting principle to assist a number of banks with Real Estate Investment Trust problems.

B. Recently a similar accomodation was made to assist banks with farm loan problems. This included a change in Accounting Principle 15 which has direct applicability to the debt problem.

C. The Comptroller has in place and functioning its "Allocated Transfer Risk Reserve" which permits it to specify how much each bank must write off of a given country's loans each year.

A minimum of ten years will be required to write off a portion of the loans to the major countries. With the Fed and the Comptroller carefully managing this matter write offs can be mandated that will not cause undue problems to any major bank.

The following schedule shows my view of the 30% minimum amount of the Regional debt that must be written off in order for each country to even hope to grow in real terms and pay interest on its remaining debt. A similar schedule is given for Mexico.

SCHEDULE I (Figures are in billions and are approximate)

LATIN AMERICA
$380B Total Regional Debt

140 Govt. to Govt. (i.e. Paris Club)

240 International Banks (of which $90B is owed to U.S. banks)
$380B

$ 50B write off of Govt. to Govt. loans
80B write off of loans by International Banks (of which about $30B is U.S. bank portion)

The U.S. bank portion of $30B over ten years is $3B each year. Depending on how this is managed, the major banks should not have to write off more than $80 million each year.

MEXICO
$100B Total Foreign Debt

25 Govt. to Govt

75 International Banks (of which about $25B is owed to U.S. banks)
$100B

$12B write off of Govt to Govt.

25B write off of loans by International Banks (of which about $9B is U.S. bank portion)

If the $9B is written off over ten years, this is $900 million per year. Even the major banks with concentration should be able to handle this without problems.

Representative OBEY. Thank you both very much. Let me simply say that I think both of you have driven home most of the points which I wanted to see driven home in this hearing this morning. I appreciate the fact that both of you have been dissenting voices, but as is the case with so many issues, that's often what we need in order to arrive at something other than a conclusion which is nothing but group thinking stamped on a whole number of issues.

Let me ask you a series of questions, most of which you have already answered, but simply so that we can get in little bits in the record specific responses to each of those questions.

Before I do that, let me simply add that I think we had a rather distinguished voice added to your side of the debate this morning. I assume you saw Helmut Schmidt's conclusions that the Third World debt is largely uncollectible.

Let me simply ask a series of specific questions.

As you know, the recent JEC report to which you referred showed that the combined profits for the nine large U.S. money center banks topped $3.4 billion for 1985.

Given that fact, in your judgment, would interest rate concessions threaten the safety and soundness of the U.S. banking system or would they, instead, put it on a more stable foundation and more accurately reflect the true profitability of those money center banks?

Mr. LORENZ. Mr. Obey, it would not threaten the banks. Of course, the $240 billion—or let's say the $90 billion that is roughly owed by Latin America to the U.S. banks and should be written off is a major number and if this were done in 1 year there would be—I mean, if they simply repudiated interest on the whole thing, it would have a major impact. But we are not really talking about that.

First of all, we're talking only about forgiving interest on the medium- and long-term government sector loans. In the case of Mexico, that's around $45 to $48 billion. If we were to do that, that would not destroy the profit and loss statements of the banks.

Now even if you handled it as I suggest as a regional problem and you say that the U.S. banks are going to have to write off over 10 years $30 billion and stop collecting interest on that from day one, that's not going to—I mean, sure, its going to hurt and the stock security analysts and the shareholders might not like it, but it's not going to eliminate earnings. It's only going to I think by the time you actually came to do it what it would do is simply lessen the rate of increase or the rate of growth in bank earnings. It would not cause them to go down.

Representative OBEY. Certainly the numbers you indicated in the last part of your statement tend to bear that out.

Another question just for the record. How do you think the stock market would react? How do you think stock market and money market would react if you had the kind of actions taken that you suggested?

Mr. LORENZ. Well, you saw in—was it 1984 when Manufacturers Hanover or last year it was 1984——

Mr. BAILEY. You mean Continental Illinois?

Mr. LORENZ. No. When Manufacturers Hanover announced that they were applying this rule of not taking into earnings Argentine

loans, you had a very positive market reaction. Any knowledgeable observer of this is upset and concerned that this is an unresolved problem that has the potential of causing major damage to the banking system until it does get contained and resolved. So if you take steps that are viewed as positive, then the market reaction is going to be positive.

I think one reason the price-earnings ratio of the banks are so low today is because this is an unresolved problem.

So the market reacted very positively when Manufacturers Hanover took what on the suface was a hit because it improved the problem. It was a proper way to recognize the problem so the market reaction was positive. And I think you would find that to be the case if we had a managed way out of this mess as opposed to taking unilateral action which the market I don't think would like. You have to be very careful here. Nobody should ever use the word "default" or "moratorium." The proper euphemism for this is debt restructuring.

But if Mexico takes a unilateral debt restructuring where there is no involvement on this side, I think the market would view that as negative.

Representative OBEY. What you're really saying I think is summed up in that first chart. I know it's pretty difficult to see given the lights in here. But the first set of graphs on the bottom part of the chart demonstrate what the level of debt was in 1982 for each of the major countries. The rear set of bar graphs indicate how that debt has grown and how that mountain of debt has been pushed backwards from 1982 to today.

And I think it indicates clearly that that is certainly not a long-term solution, by simply increasing the total indebtedness and moving it into the future and meanwhile restricting the economies in the process which limit their ability to buy our goods or to develop their own economic growth pattern.

And what you're suggesting is that if we were to face this now and if we were to have this kind of restructuring that you're talking about, that in contrast that would be a way to get on the trend line to a long term, if not a solution to the problem, at least the long-term management of the problem in a way which would have positive effects on our economy and positive effects on their own economies.

Mr. LORENZ. Mr. Obey, on specifically U.S. exports to this country, when you look at U.S. exports, a large volume of industrial exports—spare parts, equipment, that kind of thing—have taken place.

Last September, before I retired, we looked at 21 first-class Mexican private sector companies. We were getting requests to waive the clause in our loan agreements that prevented them from increasing dividends and we began to wonder what this was all about. So, we took all 21 companies and we took a composite view of their statements.

I was shocked at what that study produced. These were—I mean, I've known the people and I've known some of these companies for 30 years. They were always undercapitalized, good companies, well-managed companies, undercapitalized, doing twice with their cap-

ital what we would do, constantly expanding, constantly putting in new plants, new products, expanding their technology.

What we found last September is that they had become financial service companies. They didn't have big numbers in spare parts and inventory and accounts receivable. They had big numbers in peso bonds, government bonds, in certificates of deposits with the banks. They were no longer industrial companies.

On a composite, 40 percent of their assets were now financial assets. Well, that's a factor of loss of confidence in their government. It's a factor of the inflation rate in their economy. But it has the effect of they are not importing our—they don't even want to import our spare parts and new machinery under these circumstances.

So that has to change. You just have to create a situation throughout the region where that is going to change before you can expect any improvement in the trade pattern.

Representative OBEY. Let me ask two more questions and then ask Mr. Scheuer for his questions.

The average citizen on the street who happens to walk into this room this morning or watch over these cameras what we're talking about is probably inclined to say:

> Well, there those guys go again. They're just talking about some far-off problem. It's an esoteric problem and, good gravy, what are they talking about when they're talking about writing down foreign countries' loans? There goes Uncle Sucker at it again.

That's the stereotypical response when you first raise it.

I think what we need to do is to try to draw for that average citizen on Main Street a picture of what this problem means, what this situation now is doing to the American manufacturing sector, to our exporters, and to our farming sector.

Would either of you like to comment on what this problem means on Main Street here at home?

Mr. BAILEY. Well, as I say, according to our calculations, the international debt crisis has cost the productive sectors of the creditor countries about $140 billion the first 4 years of the crisis, 1982, 1983, 1984, and 1985.

Now, that is made up of principally the following components: reduced exports, increased import competition, and lost jobs. I mean, those are the three main components.

That is a figure which includes all the creditor countries, not just the United States, but it indicates that sectors which had really nothing to do with creating the debt crisis have had a major negative impact imposed upon them as a result of the debt crisis, whereas the banks by and large have not until now been very seriously hurt by the debt crisis. In my opinion, they will be, but that's primarily because they have not been willing to face up to the nature of the situation nor have they been encouraged to do so by the U.S. Government. In fact, it has been quite the contrary.

The first memorandum I wrote as a Government official was on an impending financial crisis. That was in March 1981. That was dismissed instantaneously as being alarmist nonsense. The following month, Poland went bankrupt and that was then seen as being an isolated situation which has really no relationship to anything else.

In the rest of 1981, a good deal of the rest of Eastern Europe went the way of Poland and that was, of course, looked upon as being these feckless Communist governments being unable to manage their economies and so on and so forth and, as a matter of fact, there was a good deal of glee within certain segments of the U.S. Government of the financial crisis that Eastern Europe was going through.

Then, of course, the LDC's began to collapse one after the other, and the answer at that point was that it's a temporary liquidity shortage, as Bob Lorenz pointed out. It is not now and never was, in the case of most of these countries, a temporary liquidity shortage. And that was easily proven.

One of the most frustrating things about this whole situation is the unwillingness to look at reality and recognize it for what it is, and the agencies that are most responsible for this, aside from certain of the major U.S. banks, are the U.S. Treasury, the International Monetary Fund, and the Institute for International Economics where Bill Cline did a study which was fatally and obviously flawed from the very beginning. I attended any number of meetings with Treasury officials. They always brought Cline's pamphlet with them on this subject and waved it around like Qadahfi's little green book. Most of them, I'm sure, had never read it. They only read its conclusions that it's a temporary liquidity shortage and they used to repeat that like a bunch of——

Mr. LORENZ. "In three years at three percent growth in the industrial countries, the problems will all be over with."

Mr. BAILEY. Yes, well, 10 years steady growth. That was one. There's no point in going into it. For one thing, it left out Poland, the sixth largest debtor. And when asked about it, the reply was, "Well, we can't get the data," which of course is absolute nonsense, but it would have changed the conclusions, which is the reason it was left out. Anyway, this is neither here nor there.

The fact that it was so influential is not Mr. Cline's fault. It's the fault of the people who allowed it to be so influential when it was so fatally flawed.

We were being warned about the impending bankruptcy of Mexico for weeks prior to Silva Herzog and his band of merry men coming up to Washington in August 1982. Nobody did anything. During the entire weekend, Secretary Regan was playing golf. I could go into a lot of interesting anecdotes about the way this whole situation was handled, or rather it was not handled. The Treasury refused to do any contingency planning at all. Even when the President ordered a national security study of the debt situation, Treasury absolutely stonewalled doing any contingency planning.

The reason given was that if they did any this would leak and that would panic the market. I and a number of other people in the Government argued very strongly that the fact that nobody was doing anything is what was panicking the market.

The Federal Reserve and the FDIC did effective contingency planning with reference to the effects of all of this on the U.S. banking system, which is a different matter from the debt crisis per se, and their contingency planning was very effectively put into place when Continental Illinois became insolvent in 1984, which

demonstrates the effectiveness of certain kinds of contingency planning when you know perfectly well certain things are likely or may very well happen.

To the best of my knowledge, there is still no contingency planning for a major—sorry to use the word, Bob—default on the part of a major debtor country. I may be wrong about that, but if there is I don't know about it.

Mr. LORENZ. Well, I think there is, Norman, as far as the banks are concerned, but beyond that, there isn't.

Mr. BAILEY. You mean by individual banks for themselves.

Mr. LORENZ. Yes.

Mr. BAILEY. Oh, yes.

Mr. LORENZ. If anything happens that really puts it to any of the major banks, there are four or five different contingency plans that could be implemented.

Mr. BAILEY. Oh, sure.

Mr. LORENZ. But only as far as the banks are concerned.

Mr. BAILEY. Right.

Representative OBEY. So, what you're saying, in effect, is that American manufacturers did not create the Third World debt situation and the American farmers did not create the Third World debt situation and yet you're saying that they and other sectors of the economy have suffered about 140 billion dollars' worth of damage?

Mr. BAILEY. Yes; they and the other creditor countries.

Mr. LORENZ. That has a terribly major impact. Your study points out that American industry lost a million jobs. When you consider that a million jobs probably support another 7 or 8 million jobs in barbers and grocery stores and what have you, it has a tremendous impact.

Representative OBEY. So, what you're saying is the way this happens, if we continue to manage this debt this way, the way this impact occurs is that the Latin American countries are told, "Your first obligation is to repay the debt that you owe to American banks." Banks are encouraged to lend more money to Third World countries so that they can repay the interest that they owe those banks. We shove that mountain of debt forward, as the first graph shows, and what that means is that because Latin American countries are told "Your first obligation is to pay off prior American bank loans, therefore you cannot use your foreign exchange to make domestic investments that would accelerate your own economy." That means they cannot buy products from American companies such as J.I. Case or any others trying to do business with Latin America. That means a loss of jobs to us here at home. It also means that because agriculture is often the only way that these countries can generate the foreign exchange which they need, therefore, they then are obligated to add more to their agricultural production and often that is to commodities which are already in surplus and that means, for instance, that Argentina, as the chart shows over on the left—Argentina can expand its volume of agricultural sales by a very large amount but the value of those sales is negligible because this entire process helps drive down the world market price for these commodities which in turn not only hurts farmers in Argentina but it hurts American farmers and con-

tinues to drive down worldwide commodity prices. That's essentially what you're saying. Isn't that correct?

Mr. LORENZ. Yes; that's all very true. There also is an implied inflationary specter in this whole thing because to the extent that you create a problem in the banks, if you look at what happened with Continental Illinois, at its high point, the credit extended to Continental Illinois was $12 to $14 billion. Now, if that is done with any number of banks, then the inflationary impact of that would be extremely destructive. The man on the street would notice that in what he pays for a quart of milk very quickly.

Representative OBEY. You're not asking that the IMF be abolished. You're not asking that it be abandoned. You're not asking that the banks totally write off the loans.

You're asking for a rational restructuring?

Mr. LORENZ. Yes, Mr. Obey; and I should say that when I say that the Mexican public sector medium- and long-term debt, that amounts to $45 billion and is the segment of the Mexican debt that we're really talking about writing off, I don't mean to imply that we would write off all of that. The Mexicans obviously can pay x amount of dollars. So, there may be only half of that, probably no more than $20 billion of that, would really have to be written down by the banks.

So, that you have to look at it from that point of view, too. You're not talking in any of these countries about all of their public sector term debt. You're talking about a percentage of each country's debt.

Representative OBEY. Mr. Scheuer.

Representative SCHEUER. Well, I very much appreciate your testimony. It's beginning to bring out some degree of rationality into our whole thinking about Third World debt.

We have heard a lot of Alice in Wonderland double think. When farmers can't meet the debt on their land, they are deemed not insolvent. Nobody looks ahead 50 years to see whether all kinds of fancy restructuring and zero interest loans could bail them out. They are foreclosed. They are deemed not insolvent but bankrupt.

And if banks make too many of these loans, they are deemed not insolvent but bankrupt. Nobody steps in to save them. Tens of thousands of farms have gone under in the last few years and a very large number of small- to middle-size banks have gone under, too.

But with foreign governments, it's different. We can't foreclose. We have to do something else. But I think not to use the word "bankrupt" defies everything that we know about words. The red queen instructed Alice, "A word means what I want it to mean, neither more nor less." You can't say that these Latin Americans are insolvent. That defies everything that we were taught in college or accounting school or whatever about what insolvency means. They aren't insolvent. They are bankrupt. There is no conceivable hypothesis under which these countries are ever going to be able to repay these accumulated debts of interest and principal and it's bizarre for our country even to think about loaning them more money, giving them more debt on which they're going to have to pay interest and principal in the future so that they can pay interest on past debts on which nobody ever expects them to

pay amortization. That defies every known rule of normal economic conduct, both domestically and internationally.

Of course, we have a great dilemma there. These countries are going to refuse to pay more than what they can comfortably afford. They will not squeeze their citizens and they will not squeeze their economies.

The President of Mexico was on a radio show on Sunday, President Miguel de la Madrid, with John McLaughlin. Let me just give you a question and answer. He asks, "Are you contemplating a modified default?" Answer: This is the President of Mexico: "Well, we've been renegotiating the terms of payment of Mexico's enormous foreign debt since the beginning of our administration. We have achieved this in such a way that Mexico continued to meet its obligations," a classical example of double think and double talk, but then he continues, "But the drop in oil prices has obliged us to restate the terms of payment of our foreign debt. When I say that Mexico can only pay what it is able to pay, I'm not making a political postulate." He really is and there's no reason why he shouldn't. Those are the facts. "I'm affirming a reality," and that's a political reality as well as an economic reality. "It is the same relationship that any debtor has with his creditors. He cannot pay more than his economic condition permits."

Question: "Are you contemplating a plan like Alan Garcia in Peru, that you will pay according to your trade revenues and the size of these revenues?" Answer: "We believe that we have to gauge the country's capacity to pay by its foreign currency earnings and also by the Mexican economy's need to grow."

That means they are going to look at the health of their own economy, their need for domestic investment. They are going to look at their foreign country earnings and they are going to give you presumably in good faith what they can, but not to make their citizens suffer, because otherwise they will have a revolution on their hands and blood running in the streets, and not to suffocate the economic growth of their country, which is their own economic future. There's no other way of saying it.

So if you take that standard—and it's a perfectly reasonable standard and de la Madrid is probably only saying honestly what any Latin American chief of state would say, "We have our own economic needs, some percentage of foreign currency less an amount that we need to invest in our domestic economy."

I think one would have to admit that there's absolutely no likelihood—there's no theoretical possibility that these loans are going to be paid off.

And the question is: What policy by our country is most likely to achieve some degree of stability and serenity and progress in these countries in the years ahead? There's no point in our giving away billions of dollars in economic aid and food aid and social aid and family planning aid and so forth if we're crippling these countries in their own ability to get on their own feet.

Of course, I think we all have to admit that most of their problems are internal. Mexico has profited enormously in the last decade from oil income and you have to wonder what happened to it. I went down to Mexico with a congressional group a few years ago. We saw not this President but his predecessor, and I asked

him if they had any plans of investing some of the oil revenue that the government was enjoying in appropriate technology, intermediate technology, in labor intensive enterprises that would give jobs and that would use local raw materials, provide commodities or products that were of use to the Mexican economy. And he fumbled and he fumbled some more and he totally evaded the question. He hadn't thought about it and didn't want to think about it.

What we've seen in these countries is gross mismanagement of resources and no amount of infusing new loans or our writing off existing loans is going to help until they get their act together. In Mexico, you have a very crippling degree of government ownership of hundreds and hundreds of major industrial corporations of all kinds. We have to say that corruption is a part of it. We have to say that the flight of capital is a major part of it. We know that Mexicans are not investing in their country. They're sending their kids and their capital here and to numbered bank accounts in Switzerland.

Just to ask sort of a devil's advocate question, what would be wrong with our Comptroller of the Currency or our banking system saying to American banks:

> We want you to revalue these loans the way you value any loan. We want you to look at the realistic likelihood that any of these loans are ever going to be repaid and we want you to revalue them and write them down over a period of 5 years or 10 years or whatever, but honestly revalue them for the benefit of your stockholders, for the benefit of the public that may be buying your securities or may be investing in your banks, and for the benefit of our country so that we can once get this thing behind us.

The banks are culpable. They invested in it. They happily extended loan after loan after loan in these developing countries when, if they had applied the same criteria to those loans as they apply to domestic loans, they never would have done it. By every banking standard, these were no-nos. These loans were absolutely uneconomic from every point of view.

Why don't we write them off, let the banks—by normal banking criteria? If it means writing off 50 percent of them or 60 percent or 30 percent, ask the banks to write them off over a period of 5 or 10 years and then do what is going to happen anyway but do it graciously? Say to these countries, "We're not going to try and bleed every drop of blood from you. We're not going to try to kill off any domestic investment." This is what we want to encourage from the long-term point of view. "We're going to write off a lot of these loans. We're going to try to help you get on your feet."

Wouldn't that be a better philosophy than the business of kidding everybody in the world, kidding our own public, kidding their publics, lulling them into continuing the failed policies of the past, both the banking community and these governments, by saying:

> We're going to give you a further loan that has interest and amortization payment schedule for the next umpteen years in order for you to pay principal on past loans on which you've defaulted on which you'll never pay amortization.

Mr. LORENZ. Well, yes, I think so. That's really what I am suggesting in that fourth point. As you know, Mr. Scheuer, there is a market for these country loans, like the Russian Imperial bonds. A bank with a loan to Mexico can go to the market and sell that in the market at a discount—I think it's running now about 45 per-

cent—the discounts are quite high at the moment. The discount varies from country to country. It's an 80 percent discount for Bolivia and maybe a 10 or 15 percent discount for Colombia. But the market is there and my fourth point is really writing off one-third or 33 percent of the American bank debt and that may not be enough. Maybe it should be 40 or 50 percent. But certainly it's a major step in the right direction.

Representative SCHEUER. I agree with that.

Mr. LORENZ. I also compliment you on listening to Mr. de la Madrid because what he is saying should be listened to and it is being said in every other capital in Latin America by every other chief of state down there and as I said, they said jointly in the Cartagena declaration. The Mexican President has, since February, been clearly indicating that at some point in the future he is going to declare, if he can't do it any other way, unilaterally a moratorium on debt payments. And that I think is imminent.

Representative SCHEUER. And that's likely to be repeated in a domino effect, don't you think, by every other developing country in Latin America?

Mr. LORENZ. Sure.

Mr. BAILEY. Let me just comment briefly on that, Mr. Scheuer. Again, I want to compliment you on getting to the heart of the matter because that's exactly what Bob Lorenz and I are saying. We are saying that it is not an unsolvable situation unless you define it wrong and take the wrong actions, and that's what's been going on for the last 4 years. We've been taking a situation which is not insolvable and making it worse all the time.

Representative SCHEUER. I totally agree.

Mr. BAILEY. The situation is worse now than it was 4 years ago, substantially worse, as demonstrated by that bar chart over there. What needs to be done is to recognize the nature of the situation, to take reasonable steps to deal with it as it is, not as we wish it would be, and to do so in a cooperative way with the debtor countries saying to them, "We recognize what your problem is. We are willing to do so and so, if in return you are willing to do such and such." And that's exactly what I meant by saying that the incentive in the Baker plan is not only insufficient, it's really a disincentive. We're saying to these countries, "We want you to do these things in return for which we will put you $20 billion more in debt over the next 3 years."

Now I defy anybody in this room to accept a deal like that and it has, in fact, not been accepted by the Latin American countries or by the other debtor countries and it has not been accepted by the banks. The banks, in order to make the Treasury happy and everybody else, of course, will give lipservice to it, but they have not in fact done anything about it. In fact, quite the contrary, there is a net outflow of bank capital from these countries to the United States.

I would also like to point out that the Philippine Government announced some weeks ago that they were going to limit their debt service payments to 25 percent of foreign exchange earnings. Nobody reacted to that because nobody wants to be mean to Mrs. Aquino, but it's exactly the same kind of announcement that Alan Garcia made in Peru.

Representative OBEY. Well, what you're saying, gentlemen, I think, is that we should take charge and lead the way toward restructuring of this debt situation or Third World countries will individually. And if they don't, we will continue to suffer the economic consequences as well as they.

And left unspoken here this morning, except for Mr. Scheuer's comment, is also the point that we have seen a lot of progress politically in Latin America in the last few years as a number of countries have moved from despotic authoritarian regimes to democratically elected regimes, and that a good deal of that is at risk if we don't find some other way besides building that mountain of debt and moving it forward a few years.

Representative SCHEUER. Could I ask one more question?

Representative OBEY. Sure.

Representative SCHEUER. I would like to ask you about the concept of restructuring debt, stretching it out and reducing interest rates.

You take the actuarial value of a debt that's stretched out with reduced interest rate, if the interest rate approaches zero the actuarial value of that debt will also approach zero. Many of our soft counter loans are outright grants or 80 or 90 percent grants.

Just to clear the air now, rather than restructuring debt, stretching it way out in the future with very low interest rates or deferred interest that you talked about, no payments for 4 years, wouldn't it be better for us to call a spade a spade and say, "We are declaring these loans, 40 or 50 percent, kaput. We're wiping them out." And if there are any further influx of capital from our country is needed in these communities, isn't it better to give them on a grant basis, which is exactly what you're doing anyway when you give a 40-year loan at 2 percent interest. Any actuary would tell you that is 87 percent or 90 percent a grant. Why not call it a grant and avoid all these constant emotional happenings where the due date comes and they want to put on another loan to pay back interest and we go through all of this ridiculous, absurd, [illegible]ce in Wonderland mumbo-jumbo, when basically what we're talking about is loans that aren't worth the paper they're written on? Wouldn't it be better just to acknowledge that fact and if they need further infusions of money call them grants in aid and then at least we can sit down with them and say, "Here's a grant in aid. We want to set some conditions on this. We want you to stop certain subsidies. We want you to get a handle on your galloping population growth rates."

You're absolutely right. Mexico has 1 million people a year, new kids, 15, 16, and 17 year olds coming into the job market. They have never in their history produced more than 200,000 or 250,000 jobs a year and they're not even producing that now. Between now and the end of the century, the Latin American economy is going to have to produce 4 million new jobs a year. Now our economy, which is five times the Latin American economy, has never produced more than 2 million jobs a year. So they would have all of a sudden to produce 10 times the jobs in relationship to their economy than they have ever done before and that we have ever done before.

At least if we made the whole proposition of new capital inflows to them on a grant basis we could sit down and say, "Here are the things that you have to do. You have to do something about your galloping population growth rate. You have to do something about elementary education so that you have a literate population. You have to do something about moving to some kind of a fair democratic system and not do as they've done in Mexico in the last year or two, overturn the clear results of state elections, thwarting the wishes of the people and creating more instability and less confidence and encouraging capital flight overseas.

Wouldn't that be a more rational approach?

Mr. LORENZ. Well, it would in theory, Mr. Scheuer, but is Congress willing to put up the bucks that it's going to take to do that?

Representative SCHEUER. But those bucks have been lost.

Mr. LORENZ. No, but you're talking about in the future, new capital loans in the future being given as grants at 2 percent interest or something.

Representative SCHEUER. No. No interest.

Mr. LORENZ. All right, no interest.

Representative SCHEUER. A 50-year loan at 2 percent is a grant.

Mr. LORENZ. But you're talking about billions of dollars now in Latin America.

Representative SCHEUER. But at least we know what we're doing. We're not kidding ourselves.

Mr. LORENZ. Well, that's true.

Representative SCHEUER. When we let our own banking system be lulled into a totally false sense of security because they feel someone is going to bail us out sooner or later, there isn't going to be any accountability for our mistakes, we never will be held responsible for our errors, no matter how gross they are, so they go ahead and loan billions. And now our country, as a country, is stuck with them and the Federal Government refuses to force the banks to look at these failed investments, these worthless investments and a failed portfolio for what they are, as they would in any domestic loan that these banks make.

Isn't it time for us to take the scales off our eyes and look at these things as they really are?

Mr. LORENZ. Sure. This is what Norman and I are saying.

Representative SCHEUER. Exactly. And I'm looking to you for support. I've been a voice in the wilderness. So is my chairman, Mr. Obey.

Mr. LORENZ. Well, I hope you are able to get more people to listen to what the Latin governments are saying because we're creating a vacuum that is going to be very unhappy when it gets filled.

Representative OBEY. Gentlemen, let me thank you both for coming. I was suppose to be in the Rules Committee 5 minutes ago on a little Latin American matter called Nicaragua.

Thank you both again for your frankness and your lucidity. I appreciate your time. The committee stands adjourned.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]

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